



Modern Business

A Series of Texts
prepared as part of the

Modern Business Course and Service



Registered Trade Mark
United States and Great Britain
Marca Registrada, M. de F.

Alexander Hamilton Institute

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(1909)

AND FIRST EDITOR-IN-CHIEF

OF THE

MODERN BUSINESS SERIES

International Exchange

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PREFACE

International exchanges have an unusual interest at the present time, and there is much confusion of thought in regard to the influences which fix exchange rates. They are in a highly sensitive state and like a person with shattered nerves react somewhat violently to changes in external conditions. This obscures to the onlooker the working of the fundamental principles which govern international payments. An examination of the seemingly mysterious but in reality simple underlying principles of international exchange should prove interesting not only to the exporter and the importer, but to business men in general who are concerned in watching the factors which make for a nation's welfare.

It would be impossible to understand exchange in its present dislocated and abnormal state without a thoro knowledge of its operation under normal conditions, and for this reason the basic principles which govern exchange under the latter have been fully explained. This discussion of exchanges under the normal gold standard is followed by a somewhat detailed analysis of exchange conditions for currencies based on a silver standard and an irredeemable paper standard, which under present conditions represent the more usual exchange relations.

In preparing the present volume, we have drawn largely upon the material furnished by Mr. E. L. Stewart Patterson, Superintendent of Eastern Townships Branches of the Canadian Bank of Commerce, to whose ripe experience and profound knowledge of the subject of international exchange a considerable part of the work is due.

It is a pleasure to record also the invaluable assistance rendered by Dr. Jenks. His keen criticism and ripe knowledge of foreign currency conditions gained by first-hand observation since the close of the World War have done much to perfect and enrich the presentation of the subject here given.

JOSEPH FRENCH JOHNSON

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INTERNATIONAL EXCHANGE

CHAPTER I

THE EXCHANGE SITUATION OF TODAY

1. *The established order crumbles.*—"In August, 1914," said Hartley Withers, "civilization went into the hands of a receiver, the God of Battles." His grip on the destinies of mankind has been broken but not entirely shaken off. What has been rescued from his grim hands is frayed and tattered, and the patient labor of many years will be required to repair the ravages of war and bring the affairs of the world, both political and economic, to an orderly basis.

No nation of the world, whether a belligerent or not, has failed to feel in some degree the consequences of the world struggle. Into every nook and corner of our business life its destructive fingers have reached and have twisted out of shape the old established order. It is only natural that these many changes should find their chief expression in international exchange, for here business relations appear in their world aspect.

2. *International exchange and civilization.*—That foreign exchange, the adjustment of all our financial

relations with the world beyond our borders, lies at the very basis of civilization is no mere figure of speech. Attempts to formulate in words just what the mind pictures by such comprehensive ideas as "civilization" are likely to be unsatisfactory. They say too little to be satisfying or they say too much to be concise and definite. One essential of civilization which all recognize, however, is that of orderly intercourse among men of the same nation and, as civilization advances, of different nations. Isolation whether of the individual or the nation is the contrast to civilization. Whatever hampers and impedes such intercourse promotes isolation, whatever facilitates intercourse between men and nations promotes civilization.

The first effect of the Great War on the United States was to break down the long established exchange relations between New York and London and other financial centers. It seems not unlikely that the reestablishment of stable exchange among the nations of the world may be the last step in the economic reconstruction thru which the world is passing. International exchange touches the heart of the economic situation past, present and future.

3. *Interest of the unusual.*—When business moves along in its accustomed gait we think very little of its operations, and we take as a matter of course the delicate adjustments of its various parts, just as a man in good health gives little thought to his digestive system. In normal times the slight fluctuations of inter-

national exchange may be of moment to the exporter and the banker—they are his professional interest—but they are of little concern to the business men of the nation at large. International payments which involve no shipment of gold arouse little interest in the business world. But when gold is exported or imported attention is immediately drawn to the fact, and from one end of the country to the other the daily press gives explanations more or less accurate of what is taking place.

Ever since the great conflict of the nations broke out in August, 1914, the disorder in our exchange relations with foreign countries has been followed from day to day with absorbing interest by men of business, as well as by the general and financial press. The machinery which determined the in-and-outflow of gold and thus regulated the rates at which adjustments between different countries were made was stopped. Violent fluctuations in these rates appeared and while, thru governmental rather than commercial means, these rates were steadied during the war, the period since the Armistice has been one of great variation and uncertainty.

4. *Fluctuating standards, national and international.*—In international relations such fluctuations in exchange rates cause disorders of the same nature as follow in domestic affairs from variations in the money standard. It is not necessary to depict in detail the difficulties which grow out of a fluctuating paper standard of money. Changes in its value in-

roduce an element of uncertainty into every business relation. Men live from day to day, not knowing what the morrow will bring forth. Business arrangements become a series of temporary makeshifts. Men are unable to work and plan for the future because that future is vague and uncertain. Business is reduced to a minimum, and under these conditions the foundations of progress cannot be laid. Business does not stop,—it cannot stop—but it lacks enterprise and hope.

It is the same in international relations. The needs of nations remain as before. Interchange of commodities between the different parts of the world cannot cease. But with rates of exchange fluctuating from day to day intercourse between the nations is hampered in the same way as if tariff barriers were shifted frequently and capriciously.

5. *Normal exchange relations.*—In part the outgrowth of national needs for commodities which could not be produced at home, in part the outgrowth of political and financial relations, there had grown up in the years that preceded the War well-established commercial and financial relations among the nations of the earth. They were not fixed and immutable, but subject to constant tho from year to year relatively slight changes as conditions in the different countries varied. The economic literature of the day consisted in no small part of a discussion of how changes in one country affected conditions in another. It is a truism that the business structure of one coun-

try is only part and parcel of the business structure of the world at large. International exchange therefore reflects both internal and external conditions.

6. *Internal change wrought by war.*—Separating, as far as it is possible to do so, internal from external conditions, let us briefly summarize the events and legacies of the Great War which have entirely thrown out of balance the traditional exchange relations among the nations.

Among the belligerents there was a great destruction of productive property, and this destruction was not evenly distributed. Belgium and northern France were laid waste, and the fruits of centuries of the up-building process were wiped out. Other belligerents escaped this fate tho the Allied nations, particularly Great Britain, and some neutrals suffered considerable losses in shipping.

Among the belligerents again there was a great destruction of man power thru the sacrifices of battle and disease. Tho the phrase man power is frequently given a purely military meaning its significance for the world's production cannot be overlooked. Economists may speculate whether in certain areas there may not be overpopulation, but with a given population, none of them would look for any benefit from the destruction of its most active and productive elements. And again it may be noted that this destruction of life was not evenly distributed among the belligerent nations.

In all the nations participating in the Great War

there was further a great destruction of potential wealth, thru the diversion of industry to the manufacture of the means of warfare, thru the attendant taxes and the huge legacy of debt which has been left for future generations to liquidate. Nor was this burden evenly distributed.

Nor could the neutral nations wholly escape the direct internal effects of the war. This was especially true of the Netherlands and Switzerland which were obliged to make relatively large military expenditures for the defence of their neutrality. The smaller neutrals in Europe and the larger ones of Latin America were indirectly drawn into the economic turmoil thru being cut off from sources of supply for their manufactures and personal consumption, and thru the difficulty in some instances in finding an outlet for their native products.

7. *Monetary disturbance.*—Thus during and after the war the nations have staggered under its burden. Their whole economic life was directed to the single purpose of warfare and all the checks and balances which guided it in times of peace were set aside. Nowhere could the monetary standard be maintained in its full integrity. Gold which had generally been the background if not the actual embodiment of the monetary circulation became exclusively a factor of government finance rather than the mainstay of commerce. The convertibility of currency into gold was suspended, and the only check on the issue of currency which civilization has established as effective ceased

to operate. Paper money under various names multiplied in the different countries at different rates, and suffered varying degrees of depreciation as revealed in the rise of local prices.

With such changes going on in the currencies of nations it was impossible for exchange rates not to be powerfully affected. When depreciation is uniform among a group of states it is conceivable that, other things being equal, exchange rates would not change. But "other things" were far from being equal in the world crisis and depreciation was far from being uniform in the nations concerned. Hence the fiscal relations of these nations not only with those which were able to maintain the integrity of their currency but also among themselves were shifted.

8. *External relations in wartime.*—Let us turn our attention to certain external relations. Western Europe is unable to produce all the food required for its dense population. Even before the war it drew large quantities of food from Eastern Europe and from other continents, exchanging manufactured products for it. It was the manufacturing center of the world, tho it had to draw upon other lands for many of its raw materials. The extensive commercial relations to which these exchanges gave rise had made London the financial center of the world, extending its influence into all the corners of the earth. To London, lands far and near looked for financial assistance. The loans of many governments were floated there, and by the terms of the contracts often

tied the resulting trade to Great Britain, and both British and native enterprises in all parts of the world drew their capital from the same source.

Europe at war had more imperative needs than before. It needed more food, since its own production was curtailed. It needed arms and munitions and supplies for the murderous conflict in which it was engaged. In its extremity it turned to the United States, and the increased imports of food and of war materials from that country went far to supply its need. Enormous payments had to be made in the United States by the allied governments and a violent shifting of the usual trade relations occurred. Crippled by the war and the demands which it entailed, the London market was no longer in a position to lend capital to the rest of the world. Those in South America, Canada, even in Europe itself who wanted to borrow, were forced to come to New York.

9. *Exchange before the war.*—In brief outline these are the chief changes—there are innumerable smaller ones—which have shifted and changed almost beyond recognition the customary exchange relations among the nations. What are the outstanding features of that situation then and now as they affect foreign exchange?

The significant thing before the War was the existence over large areas of international standards of value. Gold was the accepted medium of exchange in foreign payments over the greater part of the civilized world. A smaller group of nations used

silver as its basis of money. Within the group the same interchangeability existed as in the gold group. Moreover it is to be noted that as silver is a commodity of world commerce a relationship to the gold group was always calculable. Outside of these two groups there were a few nations having only a paper currency with no metallic background. It was common to speak of them as being on a paper standard, but it is to be noted that such a standard is necessarily local and is not an international standard common to a group of countries. Exchange with any one of them therefore will be governed by considerations which do not apply, or apply in different measure, to another.

10. *Present exchange situation.*—The distribution of the nations of the earth into gold standard, silver standard and paper standard countries has been completely changed by the war. Many of the leading nations are actually on a paper standard. They have not loosened their hold on gold, and in some cases their gold holdings have even increased since 1914. But paper money has greatly multiplied and gold is no longer available for local or, to any great extent, for international commerce. Silver indeed has held its own in international payments, but gold has lost for the time its former availability for international settlements.

How long the present conditions will be maintained no one can foretell. Certain it is that the nations which have heretofore used gold for local and international payments are looking forward to a return to

that basis. They hope to return sooner or later to the normal condition of the free use of gold in international exchanges. Such normal conditions embracing both the past and, it is hoped, the future have a permanent interest which does not attach to the present more or less temporary conditions.

11. *Present day interest in exchange.*—It may be remarked, however, that especially after the Armistice the United States came to occupy a commanding position in the exchange market. The interest in foreign exchange hitherto dormant or at the most confined to restricted banking circles concerned in exchange operations became wide spread. This has been part and parcel of the growing recognition of the fact that America's economic interests are not isolated but bound up intimately with the economic destiny of the world at large. Out of the extensive discussion in the press of the specific problems of foreign exchange as they arose from day to day has come a better understanding of the principles underlying exchange relations.

12. *Plan of discussion.*—Before the War it was not necessary to explain or defend the traditional approach to the detailed study of international exchanges. Writers depicted exchange conditions with gold standard countries, with silver standard countries, and with paper standard countries in this sequence, not only because it treated the different groups in the order of their importance but because

the discussion proceeded naturally from the simple to the complex.

If we were to follow today the importance of the different groups we should have to deal first with the paper standard, but in so doing we should plunge the reader into the most difficult phase of the entire subject. If we are to understand the principles of international exchange under conditions as they are, we must first comprehend them under conditions as they ought to be. That means that it would not be wise to depart from the traditional presentation of the subject which presumes the existence of gold as the international money. It does not mean that the unusual conditions of the present day can be ignored in the treatment. Nor does it mean that the emphasis on the different aspects of the subject will be the same as heretofore. Obviously greater attention must at this time be given to the factors underlying international payments between countries on a paper basis. Should any of our readers deem that the assumptions underlying the discussion of international exchange principles are somewhat remote from conditions as they are now, it would be well to remember that the conditions assumed are those which the future, it is hoped, will restore before the world grows much older; in spite of the fact that the gold basis itself is acknowledged to have certain weaknesses.

REVIEW

In what sense are stable exchange and civilization linked together?

Describe the exchange situation before the Great War.

What internal and external changes wrought by war have affected the exchange situation?

What has been and is now the relative importance of countries using respectively, a gold, silver and paper standard of value?

Note: The reviews thruout this Volume are for the personal convenience of the reader in testing his understanding of the Chapter. It is not necessary or desirable for subscribers to submit written answers to the Institute, except in a case where they may feel uncertain as to their grasp of the question under consideration.

CHAPTER II

FUNDAMENTALS OF EXCHANGE

1. *Clearing process in exchange.*—The fundamental principles of foreign exchange are simple. The actual methods of making international payments, however, and the calculations involved are somewhat technical. A student beginning the subject often rivets his eyes upon the maze of exchange calculations, technical methods and the myriads of varying circumstances which work together to fix the actual rates, thus losing sight of the underlying principles which are few and easily understood.

Every one knows that in foreign exchange the business world applies the familiar principle of offsetting one debt against another and arranging to adjust the balance either thru money or credit. This principle will be understood better if portrayed first in a simple illustration stripped of all the mechanism which civilization and commerce have developed.

2. *Settlement of equal debts.*—Let us suppose that Durant in Montreal has sold to Rogers in New York a bill of goods for \$1,000. He draws a draft for this amount on Rogers who must make payment in Montreal. If Rogers sends currency or gold, he must pay insurance and transportation costs, and this

is an added burden to his business. Now suppose that at the same time Peters in New York has sold a \$1,000 bill of goods to Martin in Montreal, making it necessary for Martin to send \$1,000 to New York. Clearly, if all four parties were aware of these transactions, Martin the Montreal buyer could pay \$1,000 to Durant the Montreal seller, and Rogers the New York buyer could pay Peters the New York seller. This would eliminate the necessity for any shipment of money.

3. *Settlement of unequal debts.*—Now let us assume that the debts in the foregoing case were not equal, that \$1,500 is due to Montreal and only \$1,000 to New York. In Montreal, Martin can settle with Durant just as before; but, in New York, after Rogers has paid \$1,000 to Peters he must still remit \$500 to Durant at Montreal. To ship this \$500 will cost something but it will be less expensive than shipping the entire \$1,500. Furthermore, the cost of shipping \$1,000 from Montreal to New York has been saved.

Multiply the four men of our illustration by thousands, and we have a picture which more clearly corresponds to the actual situation. The multiplication increases the amount of debts to be adjusted; it may also diminish the proportion of the entire debt to be settled by currency shipments.

4. *The dealer in exchange.*—It may be objected that the above illustration is unreasonable, that we could not possibly expect the four men, much less

thousands, to discover one another's doings. The objection would be well taken. But suppose that no business man in either Montreal or New York undertakes to ship currency on his own account and that there is only one banker or exchange dealer in each place who is equipped to handle such transactions. Say, further, that the Bank of Montreal sends all remittances direct to the Bank of New York which distributes the payments to those entitled to receive them in New York and that, in like manner, the Bank of New York consigns all remittances to the Bank of Montreal for distribution there. All business men in New York who owe money in Montreal will now pay their funds into the Bank of New York, and all those to whom money is due from Montreal will call upon the Bank of New York for it. The bank will know that it has certain remittances to make but that, on the other hand, it has certain remittances due from the Bank of Montreal. It will ship only the balance due Montreal or receive only the balance due New York.

5. *The exchange rate.*—The banker or exchange dealer evidently renders a valuable service, for which it is only just that he should be paid. So long as payments to Montreal equal payments to New York nothing but bookkeeping is involved, and the bank may assume the cost of this as an accommodation to its customers. Under these conditions exchange is said to be at par.

The moment a currency shipment, to Montreal for

example, becomes necessary, it is only natural that the Bank of New York should make a charge. It cannot charge more than the expense incident to procuring the money and shipping it; if it should do so business men would ship for themselves.

The bank may anticipate the necessity of shipping currency before it actually arises. If business men in New York seem to be buying from Montreal more than they are selling, the Bank of New York may begin to make a small charge for its services in remitting to Montreal, increasing the charge as the probability of shipment becomes more certain. The cost is thus distributed over a larger number of buyers, who will pay the charge rather than ship money themselves as long as it does not exceed the cost to them if they should procure the money and ship it. Under these conditions exchange on Montreal is said to be at a premium in New York.

6. *Exchange at a discount.*—When Montreal exchange is at a premium in New York, what is happening to New York exchange in Montreal? There the sellers overbalance the buyers. Sellers draw their drafts upon New York and present them to the Bank of Montreal for cash. Some drafts are coming in from New York drawn upon Montreal business men who have bought goods, and cash is received for them; but not enough to meet the sellers' demand. Under these circumstances the Bank of Montreal may refuse to pay full face value for drafts on New York, and New York exchange is at a discount.

If the Montreal sellers have specified in their contracts with New York buyers that payment must be made in Montreal, they are fortunate. They need not sell their drafts to the Bank of Montreal at a discount but may simply demand that their debtors forward the money. If the contract permits payment to be made in New York, however, they cannot do better than sell their drafts at a discount. Of course, the discount cannot exceed the expenses of shipping the money from New York to Montreal, since they can accept payment in New York and make the shipment on their own account.

This illustration shows how important it may be for a sales contract to specify whether payment is to be made in money of the seller's city or in that of the buyer's.

7. *The exchange market.*—The assumption that there is only one exchange dealer in Montreal or New York is, of course, incorrect. There are many dealers or banks in each city where drafts can be bought and sold. The Bank of New York is in competition with other banks and dealers, and, under the circumstances described above, cannot charge a premium on Montreal exchange greater than its competitors charge if it would hold its customers. In like manner, the Bank of Montreal cannot discount New York drafts at a rate higher than that of its competitors if it wants to buy any exchange.

So far it has been assumed also that New York and Montreal trade only with each other; but each trades

with every other important city in the world. In Montreal, an excess of sales to New York over purchases from her may be counterbalanced by an excess of purchases from London over sales to that point. At the same time, New York may be selling more to London than she is buying. If so, New York can pay Montreal by drafts on London, thus avoiding shipment of money. Montreal is content, because she can forward the drafts to London instead of money.

8. *Exchange centers*.—It would seem that the practice just described would lead to boundless confusion. New York might send to Montreal drafts on Madrid when Montreal had a balance due from Madrid. Montreal might then send these drafts to some other point where she owed an amount and there again they might not be needed. How could any point determine what drafts to forward to another?

This difficulty was settled in the natural development of international trade. London and New York are two points with which almost every city in the world is trading. Remittances are always being made to these points and received from them. Consequently drafts on either may be remitted anywhere in settlement of debts, and they will be acceptable because points everywhere need such drafts to make payments in one or the other city. Drafts on other cities are sometimes used, but usually they are remitted to the cities on which they are drawn or to nearby cities. Drafts on any point are acceptable

in New York or London because they have remittances to make everywhere. These two cities are the exchange centers of the world.

9. *Gold points*.—In a preceding paragraph we pointed out that the premium on Montreal exchange in New York could never go above the expenses incident to procuring the gold and shipping it. Shipping expenses consist primarily of the cost of packing, express, insurance and loss by abrasion. In a country which is not redeeming its credit money at face value in gold, it may be necessary to pay an additional amount to secure gold for shipment.

The principle which limits the premium on Montreal exchange in New York also limits the discount, except that for a time after the War there was the expense involved in procuring gold in Montreal and in shipping it to New York.

Evidently, at a given time, there is a point above par beyond which the price of exchange cannot rise, and likewise a point below par under which the price cannot drop. These are the points at which it becomes profitable to export or import gold, and are often called the gold shipping points or gold points. It must be understood that they vary with the costs of procuring gold and shipping it.

10. *Demand and supply*.—The price of exchange fluctuates between the gold points according to the shifting of demand and supply. Every sale of goods by an American to an Englishman creates a supply of drafts on London; every purchase made by an

American from an Englishman creates a demand for London exchange. American sales to England thus tend to lower the price of London exchange and purchases from England tend to raise it.

Lowering the price of London exchange in New York means raising the price of New York exchange in London and conversely. It will be seen then that every export from the United States tends to lower the price of exchange on the buying country, which means raising the price of New York exchange in that country. Every import into the United States tends to lower the price of New York exchange abroad.

11. *Exchange as a trade factor.*—Thus far we have considered exchange as a result of trade activity. For a fuller view of the subject we must also recognize that exchange is an important factor in determining the trend of trade.

How this takes place can best be explained by considering a case that is hypothetical,—and, to lend force to the argument, absurdly so. Let us assume that in New York, Montreal exchange is quoted at 75. That means that \$75 in New York in goods or money would be worth \$100 in Montreal, and of course the converse would be true. If on the face of it, Montreal is an excellent place in which to sell, it would be a bad place in which to buy. What the New York merchant would gain on his sales would be lost on his purchases or his remittance. But since this exchange relation is wholly abnormal a return to par

would be expected. If then when the New York merchant expects to cash in on his sale the rate should have advanced to 80 he would be the gainer by the rise in exchange and the hope of such gain would impel him to sell. On the other hand if exchange is falling the Montreal merchant would have no incentive to buy in New York but if from a low point it begins to rise he is likely to purchase and seek to reap the benefit of such a rise.

The assumed facts are fearfully exaggerated and frankly absurd. Yet they illustrate an important principle. Exchange variations as we have seen fluctuate within very narrow limits and one might well be skeptical whether these variations would start any such selling and buying movements as have been suggested.

Now the margins of profit on such operations are very slight. They would offer little incentive to trade to the grocer or the dry goods dealer. But there are other commodities and other markets which are extremely sensitive to changes such as these. First of all there is the money market, the market for securities of all sorts and the organized markets for grain and other produce. They operate on very small margins and thru the magnitude of their operations small profits become important sources of revenue.

Just how these various financial transactions are stimulated by exchange operations and affect exchange rates must be reserved for subsequent treat-

ment. It is important at this point to note their existence.

12. *The rôle that money plays.*—In the preceding chapter there was considerable insistence upon the rôle that money plays in determining exchange relations. In the present chapter exchange has been explained largely as a means of making payments without the transfer of money. These two standpoints are only in appearance contradictory. The relation that money bears to the exchanges is exactly the same as that which it bears to other forms of credit operations. Banking operations dispense with one use of money, as a medium of exchange, but without money they would be inconceivable. The money function is a composite one and we are apt to speak loosely of doing away with the use of money when at best we simply economize one of its uses. Back of all credit transactions whether in local or foreign affairs stands money. It is the language in which they are expressed and, more than that, it is the medium thru which credit differences are adjusted. The more highly developed the credit system the smaller will be the amount which requires such cash adjustment, but we have not yet reached a point where we can entirely dispense with its use for such purposes.

Our explanations of exchange operations have thruout had the background of the existence of money equally acceptable to all parties to the transactions. When such a condition obtains the phenomena of exchange present their simplest forms.

13. *Exchange with foreign centers.*—The fact that two communities which trade with one another belong to different nations does not of itself affect exchange relations. Exchange operations may be affected by differences in currencies but the underlying principles remain the same.

Since the explanations thus far given assume the existence of money equally acceptable to all parties we may distinguish three different situations:

(a) Where the money of two countries is identical and has completely free circulation in both.

(b) Where the money of two countries tho identical does not circulate in both but is readily convertible from one to the other.

(c) When the money basis is the same, but denominations different, with ready convertibility of one to the other with or without concurrent circulation.

If we go back a few years we find that the first condition prevailed in the relations of Paris with Brussels, Geneva and other points in the nations of the Latin Union, the second condition existed in the relations of New York to Canadian centers, while the third was found in New York's relation to London, Paris, Berlin and other centers of countries having the gold or the gold exchange currency standard.

It is to be noted that the condition of such exchanges is either concurrent circulation of money, or its free convertibility, or both combined. A word of explanation is perhaps needed with regard to the combination here noted which applies chiefly to gold.

The chief use of gold in the monetary circulation of most nations has been as a reserve for the banks. Inasmuch as the chief foreign banks are by law permitted to hold a part of their gold reserve in coins of foreign nations it is in a sense proper to say that the American double eagles stored in the vaults of the Bank of England had circulation in Great Britain. At that time the converse was not true. American banks could hold no part of their reserve in foreign coin and on receiving it had to transform it into American gold either in bars or coin.

In international exchange gold circulates by weight rather than by denominations, but there are certain forms such as the coins of the leading nations and bars of the leading mints which have the preference. It may be noted that an examination of the customs returns for gold imported into the United States ordinarily reveals that the greater part of it comes to the country in the form of American coin or American treasury bars and only a small part in foreign coin.

14. *Countries using the same money.*—If, as was formerly the case in the countries forming the Latin Monetary Union, the coins of one country circulate freely by law in another, exchange among them offers no problem. All exchange is expressed in familiar terms which allows even those not very well informed to perceive the premium or the discount. Quite similar is the situation in countries which use different coins which, however, have the same gold value, sometimes the same name. When before

the Great War New York traded with Montreal and settled its transactions by exchange operations, it was hardly aware of the fact that it was engaging in foreign exchange. The two places used the same dollar as to weight and fineness and exchange on Montreal and exchange on New York was in each case practically quoted in domestic currency. Exchange bridges the gap between two countries very simply, so long as there is the possibility of the free movement of money of the same kind. As we shall see later even the designation or value of the money unit is quite immaterial if the kind is the same.

For a while after the war Canadian exchange was at a marked discount. Such a discount would be impossible if the money in circulation were in effect of the same kind. This was not the case. As an aftermath of the Great War, Canada was obliged to depart for the time being from the gold basis. So long as the paper money of the Dominion could not be converted into gold, the gold standard which existed by law was in fact suspended. Under these circumstances the Canadian dollar was quite a different thing from the American dollar, tho under normal conditions they are practically identical.

Exchange rates between countries having the same monetary units as is the case between the United States and Canada are readily understood by the beginner because they are expressed in the same monetary language. Deviations from exact equality are

measured in terms with which the business world is thoroly familiar.

15. *Countries using different coinages.*—Since London reckons all its transactions in gold pounds sterling, and New York figures its dealings in gold dollars, exchange relations in appearance are somewhat more complicated than those which have been thus far discussed. This complexity, however, lies chiefly in the appearance. Both countries are using the same money metal, gold, and in both it is freely available for the needs of trade. The only difference lies in the coins used. But since in international affairs gold circulates by weight it is only necessary to compare the pure gold in the sovereign with that in the dollar to establish the relation in which, with exchange at par, one coin can be exchanged for the other. This ratio called the Mint par of exchange was £1 = \$4.8665. When exchange on London costs more than \$4.86 2-3 it is at a premium, when less it is at a discount.

16. *Countries with different money standards.*—Thus far we have discussed exchange relations between countries having a like monetary standard. The existence of what then becomes international money is helpful and convenient for the development of commerce, but it is not essential to it. Trade between countries on a different money standard continues and as we have seen in the preceding chapter is possibly the dominant form of international trade for the time being. It introduces, however, into the

fixing of exchange rates a variety of new considerations. For the orderly development of the subject it seems advisable to defer the consideration of these exchanges until there has been a full consideration of all the phenomena of exchange based on international money—gold. These phases of the subject will therefore receive first attention.

REVIEW

Explain the exchange as a clearing process.

How do you account for premiums and discounts in exchange?

What is the role of banker? What is meant by exchange market and exchange center?

Within what limits will exchange usually fluctuate? How are those limits fixed?

Explain how money is at the basis of exchange rates and the effect if any of different moneys of the same kind in the problems involved.

CHAPTER III

INTERNATIONAL PAYMENTS—ORIGIN

1. *How indebtedness between two countries arises.*

—The mutual indebtedness of two countries arises from a combination of the following:

Exports of merchandise

Investments abroad

The purchase of foreign securities

Payments of interest and dividends to foreign shareholders

Charges for transportation, insurance and commissions paid to foreign corporations

Tourists' expenditures, etc.

There are, of course, many other causes which affect the course of the exchanges, but the above are the principal factors in the fluctuations. Normally, the balance of payment, as it is called, is sometimes with one country, sometimes with another, and the rate of exchange accordingly rises and falls within certain well-defined limits. Between countries on the gold standard these limits are determined by the cost of shipping gold from one country to the other. The rate of exchange may be defined as the price of the money of one country reckoned in the money of any

other country, that is, the price of the right to gold of a certain established weight and fineness. As many countries have not yet removed their embargoes against gold shipments by other agencies than the governments, this price must temporarily be considered not as the price of their standard gold coin but of currency with the lessened quantity of gold behind it resulting from the increase of its amount in proportion to gold reserves.

The principal operations of foreign exchange include the issue of drafts and various forms of commercial paper, money orders, letters of credit payable abroad, cable transactions and the purchase and shipment of bullion and of foreign coin.

2. *Interdependence of exports and imports.*—If merchandise were the only basis of international indebtedness the value of the exports would have to be equal to that of the imports or else trade would practically cease. Suppose a country which does not itself produce gold, has an excess of imports, for which it could pay only by shipping gold. To a limited extent this could be done, but its supply of gold would soon be exhausted and the only way to replenish it would be to reduce the amount of imports below that of its exports. Furthermore, the loss of gold from a country induces a fall in the prices of goods (a rise in the value of money) and, owing to the depletion of the bank reserves, a rise in interest rates follows. It would, therefore, become a good country to buy from, and a poor country to sell to. Automatically, exports

would be stimulated and imports checked until the balance was reversed.

In practice, however, the exports of a country are not confined to merchandise but include other elements known as "invisible exports," which offset imports of merchandise. "Visible exports" consist of merchandise of every description, including gold; they are so called because accurate records of all goods and specie entering or leaving a country are kept by the customs and port authorities. Every vessel clearing from a port must declare its cargo before leaving, and all goods entering the country are examined and valued at the custom house. This system affords a fairly accurate record of the visible exports and imports of a country. A country's "invisible" foreign trade is so called because no such record is available owing to its nature. It consists of the import and export of services, of bonds, shares and other evidences of indebtedness and, not being the subject of government supervision, there is no certain method of ascertaining the amount and volume of these transactions. For that reason they can only be roughly estimated.

The disparity between the visible exports and the visible imports of the principal countries of the world for the year ended December 31, 1926, will demonstrate the importance played by the invisible exports and the invisible imports in adjusting the balances of the payments among the leading countries of the world.

	Imports (Last six ciphers omitted)	Exports
United Kingdom and Irish Free State	\$5,912	\$3,564
Germany	2,368	2,328
United States	4,430	4,808
France	1,928	1,936
Austria	384	239
Canada	1,008	1,283
Russia	346	303
Denmark	425	397
Sweden	398	379
Netherlands	979	701
Norway	244	181

It will be noted that the imports of the above countries with the exception of those in the United States, Russia and the Netherlands, exceeded the "visible" exports; the difference was adjusted by "invisible" exports. Such excess of visible imports does not necessarily place a country at a disadvantage, for in the case of the older countries goods are imported to pay for their services (such as freight and insurance) or to meet the interest on their foreign investments. In the case of a young country like Canada, however, the excess of imports usually consists of goods purchased with money borrowed abroad for capital expenditure, such as material for railways, factories and public works.

3. *Origin and supply of foreign exchange.*—Altho the export and import of merchandise are the basic factors of international indebtedness, the other elements which must be taken into consideration have a precisely similar effect on the balances of indebted-

ness, and they can therefore be expressed in terms of exports and imports. Summarizing what has already been said, trade between two countries on the gold standard consists of mutual exchanges of:

- (a) Merchandise
- (b) Gold
- (c) Services
- (d) Evidences of indebtedness.

For the sake of simplicity we generally consider that one country, say, the United States, trades with another country, England, just as if a statement of account were made out daily and the relative balance arrived at and settled. Such, of course, is not the case; the transactions occur among a multitude of independent merchants and bankers, whose bills of exchange on one another furnish the supply of, and govern the demand for, foreign exchange, and thus affect the price of exchange between the two countries in question. Bankers and exchange brokers in New York and London encourage the public to utilize their services for paying debts abroad, and in order that they may do this, also encourage those who have claims against persons abroad to sell these claims to the banks in the form of bills of exchange, thus enabling the banks to offset sales against purchases. In other words, the banks are both buyers and sellers of foreign exchange. A continuous process of assembling and distributing exchange is thus effected through the agency of banks, which act as clearing houses and eventually make a settlement between the financial

centers of the two countries. Should New York banks, for instance, be called upon for more exchange on London than they are able to buy, they must provide funds to meet their withdrawals by exporting gold or by some other means. As a rule, gold shipments are avoided as much as possible and the required balance in London is often created by:

(a) Buying exchange on other centers and sending to London for credit.

(b) Shipping securities to London to be sold or borrowed against.

(c) Using finance bills (Bankers' time bills).

While these expedients will receive detailed attention later a word or two of explanation may be in order at this point. In the trade between the United States and Canada, there is ordinarily a balance to be paid by the latter country. Before the war Canada was in the habit of discharging this obligation by drafts upon her largest customer, Great Britain.

When a similar recourse is not available resort is often had to stocks and bonds. There is a large number of such securities which are international in character, with as ready a sale in London as in New York. A transfer of such securities to the London market has the same effect as a shipment of gold. It can therefore be used to avoid such a shipment. Moreover the market for such securities is very sensitive. Slight variations in the exchange rate may make London or New York the better market for the sale of

securities and will set in motion almost instantly a flow of securities from one market to the other.

Finance bills which are frequently used in the circumstances noted are more in the nature of a postponement than a settlement. They may be briefly described as a temporary expedient of sixty to ninety days currency, used principally between seasons to anticipate a favorable change in the exchange rates. Exports, it may be noted, especially cotton and wheat, are not uniformly distributed over the entire year. It will be readily understood therefore that exchange will normally be low at some seasons and high at others.

These are the principal methods resorted to in the daily endeavor to adjust an excess of imports over exports; if in spite of them the balance of payments remains adverse, gold is shipped.

4. *"The United States in account with the world."*
—The exports of one country form the imports of another, and a study of the foreign trade of different countries will show that the component items of the exports and imports vary only in degree. Dean Joseph French Johnson in "Money and Currency" gives a statement of "The United States in Account with the World" (reproduced on page 36) the headings of which are comprehensive and self-explanatory and call for very little comment. The amounts of the various items under invisible exports and imports are, of course, only estimates.

The exports of merchandise exceed the imports for

the typical year under consideration, as they did in 1913, and the difference was adjusted by the "invisible imports." The statement shows that gold was both exported and imported, indicating that in the course of the year it was found necessary at times to import gold to correct a falling rate and at other times to export gold to adjust a rising rate.

The invisible exports and imports can be considered under broader classifications as net balances offsetting the excess of visible exports, as shown in the following statement:

THE UNITED STATES IN ACCOUNT WITH THE WORLD
(In Millions of Dollars)

EXPORTS		IMPORTS	
Which make the Supply of Foreign Exchange		Which cause the Demand for Foreign Exchange	
	Cr.	Visible Imports:	Dr.
<i>Visible Exports:</i>		1. Merchandise	1062
1. Merchandise	1502	2. Gold	85
2. Gold	121	<i>Invisible Imports:</i>	
<i>Invisible Exports:</i>		3. Stocks and bonds bought in foreign markets	616
3. Stocks and bonds bought in the U. S. by	500	by Americans (arbitrage included)	
foreigners (arbitrage included)	30	4. Other investments by Americans in foreign	20
4. Other investments by foreigners in the U. S.	30	countries	
5. Interest and dividends on foreign securities	15	owned by Americans	50
owned by Americans	15	6. Profits by foreigners from other invest-	30
6. Profits by Americans on investments in for-	10	ments in the U. S.	5
ign countries	10	7. Increase of American bank balances abroad	
7. Reduction of American bank balances		8. Reduction of foreign bank balances in the	10
abroad		U. S.	100
8. Increase of foreign bank balances in the		9. American tourists abroad	65
U. S.	15	9a. Americans living abroad and drawing in-	3
9. Foreign tourists in the U. S.	15	comes from the U. S.	
10. Foreign embassies, consulates, etc., in the	3	10. American embassies, consulates, etc., abroad	
U. S.	3	11. Ocean freights paid by Americans to for-	100
11. Ocean freight paid to Americans by for-		eigners	
eigners		<i>Extraordinary:</i>	
<i>Extraordinary:</i>		12. Payment to foreigners on account of in-	
12. Indemnities, subsidies from foreigners, or		demnities, subsidies, purchases of public	50
sales of public property to foreigners		property, etc. (Panama Canal)	2196
Total export credits	2196	Total import debits	

Excess of visible exports:

Merchandise.....	\$440,000,000
Gold.....	36,000,000
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Total excess of exports.....	\$476,000,000

Excess of invisible imports:

Interest and Profits (5 and 6)	\$ 55,000,000
Tourists and Embassies (9 and 10)	150,000,000
Ocean Freight (11)	100,000,000
Investments (3 and 4)	106,000,000
Special Transactions (12)	50,000,000
Balance due by Foreign Banks (7 and 8) .	15,000,000
<hr/>	
	\$476,000,000

The above statement shows that the United States paid \$305,000,000 in goods for interest and services, took over \$156,000,000 in investments, and still had a credit balance of \$15,000,000 in foreign banks.

5. *Significance of the elements in the balance.*—In the list which has been given there are certain elements the importance of which is universally recognized and appreciated and which call for more extended consideration in subsequent chapters. First in importance are the exports and imports of merchandise, the backbone of all international trade relations. They are usually the dominant element in determining the exchange rate. Next comes a group of relations which might be described as financial rather than commercial. These concern investments, permanent and temporary, and banking relations which form the subject matter of international finance and which, as im-

portant modifying conditions, must receive special considerations in a volume on international exchange.

These are the major currents of international payments. The minor currents are numerous and in the aggregate mount up to millions of dollars. They are made up for the most part of personal consumption abroad and services rendered abroad.

One of the items which looms large in the foregoing calculation is the outlay of tourists. American tourists abroad spend annually large sums of money which are only in small measure offset by the expenditures of foreign tourists in the United States. It must be obvious that from the standpoint of international trade whatever is paid out abroad by Americans for commodities or services is equivalent to an importation of foreign goods. It is immaterial whether Americans consume foreign goods at home or abroad. The point is that they must be paid for by American wealth. Similar in their nature are the expenditures abroad of American residents temporarily sojourning there, such as our diplomatic, consular and other government agents, as well as private individuals. So far as our official representatives are concerned it is clear that their expenditure is largely counter-balanced by those of foreign representatives in the United States.

Somewhat similar in their effects are the remittances made by immigrants to their kindred in foreign countries. Since the investigations of the United States Immigration Commission this has been recog-

nized to be a large sum comparable to if not in excess of that spent by tourists. Here again we have consumption in foreign lands of American funds, but the consumption is by proxy instead of at first-hand as in the case of tourists and Americans residing abroad.

Various services rendered abroad enter into the balance of payments. Probably the most important of these are the freight payments made to foreign shipowners. At the time the foregoing computation was made only a small part of American commerce was carried in American bottoms, and the balance of freight payments was a considerable item among the "invisible" imports. Similar in nature are the premiums of marine insurance. Whatever we pay to foreign companies on this account is equivalent to an import of goods in its relation to the balance of payments. Of kindred nature, moreover, are commissions paid to foreign bankers for their services in financing exports and imports. All such items may or may not be offset in whole or in part by counterbalancing items. When such services are rendered at home they are in the nature of an export, when rendered abroad they are in the nature of an import. Services of this character have always been a prominent feature in Great Britain's balance of payments.

6. *Recent currents.*—The Great War brought a tremendous change in the international situation of the United States. The demand for American goods rose to unprecedented heights, exports of merchandise were largely increased, and the difference between

merchandise exports and merchandise imports could no longer be balanced by such "invisible" imports as have been noted in the preceding pages.

In the year 1919, for example, American exports of merchandise slightly exceeded eight billion dollars, while imports of goods into the United States fell just short of four billion dollars. Not only was the United States a creditor for the excess of goods sold, but it had become a creditor on other items where it once appeared as a debtor.

In a computation for 1919, made by Mr. F. A. Vanderlip and Professor J. H. Williams, it appears that there was a balance due the United States for interest upon our investments made abroad of 122 million dollars. When Dean Johnson made the computation referred to on page 36 the situation was quite a different one. At that time, 1904, large amounts of American securities were held abroad and comparatively few foreign securities were owned in the United States. To liquidate Europe's debt to America in the early years of the War, the greater part of these foreign held American securities were sold back to the United States. In the meantime foreign nations, cities and to some extent industrial enterprises began to look to the United States for capital, and foreign issues were marketed here. As early as 1919 the interest due to the United States exceeded interest due Europe on the remainder of her former large holdings of American securities.

The building up of foreign holdings is a contin-

uous process, and the additions to these holdings in 1919 were estimated to be 221 million dollars, or more than the interest due the United States from foreign sources. The United States has been slow to embark upon this course, but it would seem to be only thru increased investment of American capital abroad that the abnormally swollen excess of merchandise exports in recent years can be compensated.

A striking feature of the computation for 1919 is that its authors assign to the United States larger receipts from freight in ocean shipping than freight payments. Nothing could characterize more concisely than does this estimate the changed situation of the American merchant marine on the high seas.

There were disturbing factors in the situation of 1919 due to the operations of the government. As a result the calculation of the situation as it affected exchanges was difficult. For purposes of comparison the conclusions of Mr. Vanderlip and Professor Williams are interesting. They are given in the following table and note.

	Credit	Debit
	(000,000 omitted)	
1. Excess of exports of merchandise and specie	\$4,328	
2. Net credit on shipping account		93
1. Government advances to finance exports, and relief		\$2,139*
2. Net export of private capital (minus interest receivable)		99

3. Government purchases of European currencies for acquisition of supplies abroad	526
4. Remittances of tourists and immigrants	350
	<hr/>
Totals	\$4,421 \$3,114
Net balance	1,307

* In strictness, the government advances to finance exports should also be omitted, since they did not represent exchange transactions, but were in fact designed to obviate the necessity of resort to the exchange market. But also, it would be necessary to deduct from the surplus of merchandise exports an equal sum, representing the exports financed by this means.

Dr. B. M. Anderson made a similar estimate for the period of January 1, 1919, to September 30, 1920. Its general tendencies are the same as those already noted. The United States Department of Commerce made in 1925 a statement for the preceding calendar year.

7. *Floating debts*.—There was an exact balance between income and outgo in the statement of Dean Johnson. It is characteristic of these later statements that so many indeterminate elements enter into them that an exact correspondence cannot be computed. The table quoted above shows, for the year 1919, a net balance of over a billion dollars not accounted for, while Dr. Anderson's calculations point to such a balance in September 1920 of over three billions. What is the significance of these figures?

In any trading process there will be at any given time a number of unsettled transactions. According to the nature of the business done these will bear a more or less fixed relation to the volume of business transacted. In times of difficulty this proportion will increase and may, unless it can be checked, swamp the enterprise.

In the trade of nations a similar situation arises. There is at any given time a certain amount of current or floating debt. Pressure to increase or decrease this amount will materially affect exchange relations. Of this the history of recent years furnishes interesting evidence. When the European War broke out in 1914 there was a sudden call from Europe for the liquidation of our outstanding debts to her. Combined with the difficulty of making remittances, rates of exchange for a few weeks mounted skyward. Later the insistent demand of Europe for our products created a contrary situation. The unsettled balances on the other side of the account grew to huge proportions and this was one of the factors contributory to the fall of exchange on all European points.

8. *Healthier conditions.*—It is clear that such unbalanced trade as we have described could not long continue. Beginning in 1920 there has been a gradual return to healthier conditions. Exports of goods from the United States gradually decreased and, reckoned in values, were only half as great in 1922 as two years before. On the other hand, after 1921

imports grew in volume, and in April 1923 exceeded the exports.

There is also evidence that the floating debt of foreign countries to the United States is being reduced by making it permanent. In other words there is a continued stream of investment in foreign obligations or in foreign establishments, apparently increasing in volume. The *Commercial and Financial Chronicle* reported the foreign securities floated in the New York market to have been 232 million dollars in 1920, 340 million in 1921, 500 million in 1923 and 1,307 million in 1925.

This general review of international finance as it affects the United States will serve to picture the manifold considerations which enter into the situation. Some of the more important elements are to receive further consideration in following chapters which will describe more in detail also the mechanism by which these transactions are effected.

REVIEW

How does indebtedness between countries arise?

What are the invisible factors in the balance of international payments? What are the visible factors?

How is the balance of visible factors adjusted?

Describe Dean Johnson's statement of the United States in account with the world before the War. What seems to have been the relative importance of the different elements of the statement?

Explain how as a result of the war the conditions of the balance of payments have shifted.

CHAPTER IV

GOLD EXCHANGE RATES

1. *Gold standard.*—Before 1914 the leading commercial nations of the world had in fact as well as in law a gold standard of currency. Under a gold standard the money unit is a definite quantity of gold of a standard fineness which is represented in the coinage of the country by coins equalling the standard in value or multiples or subdivisions of the same.

It is not at all necessary to the existence of the gold standard that such coins should pass freely from hand to hand in the daily transactions of the people. In fact the greater part of the circulation of gold consists in the fact that it lies hidden in the vaults of the banks and in the coffers of the government as a guarantee for the value of other currency, chiefly paper. The essence of the gold standard then lies in the fact that for any of the uses for which metallic gold is required it can readily be obtained by presenting at the proper place an equivalent amount of other currency. In other words it is the ready convertibility of all forms of currency into gold which constitutes the gold standard.

One of the chief uses of metallic gold is to settle the balances of indebtedness to foreign countries, in other words to regulate exchange relations.

2. *Gold exchange standard.*—There is a number of nations which have not been able to afford the luxury of the gold standard in the internal monetary circulation of the country, yet which use gold as a basis of exchange. The government fixes a definite relation between the actual currency of the country and gold, and it undertakes either directly or thru the banks to maintain this relation with gold in all dealings with foreign countries. To do this it must provide a stock of gold sufficient to meet necessary demands for foreign payments, while at the same time it takes such measures to maintain exchange rates as render those demands as small as possible. This form of monetary system will be discussed more fully in a later chapter.

Thus exchange thruout the greater part of the world was a few years ago conducted on a gold basis, and if we understand thoroly the factors entering into such exchange, the present, it is hoped, abnormal conditions of the exchange market will be the more readily comprehended.

3. *Monetary systems.*—For an understanding of the facts of foreign exchange an acquaintance with the leading monetary systems is indispensable. Each of these money units represents in theory at least a definite weight of pure gold. When theory and practice were in accord, the units of the chief commercial nations were as given in the following table.

GOLD EXCHANGE RATES

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Country	Name of Unit	Gross Weight Grains	Pure Gold Grains	Dollar Equivalent	Sterling Equivalent in Pence
Austria-Hungary	.....kronen	5.22776	4.70498	.20262	.10d
Latin Union	...franc	4.97817	4.48036	.0892	1.932
Canada and United States	dollar	25.8	23.22	1.	49.316
Denmark	....kronor	6.91415	6.22274	.26799	13.212
Germany	.....reichsmark	6.14588	5.53134	.23821	11.75
Holland	.....gulden	10.37054	9.33348	.40195	19.82
Japan	.....yen	12.86024	11.57422	.49505	24.576
Mexico	.....peso	12.86023	11.57421	.49845	24.57
Russia	.....ruble	13.27584	11.94826	.51456	25.37
Great Britain	.pound	123.27447	113.00160	4.86656	....
					or 4.86 2/3

The divergence of fact from theory in the present disturbed state of the currency in most of these nations will engage our attention later. For the present we are concerned with rates of exchange on the gold basis of a few years ago. Since the weight of foreign coins is in most countries officially given in grammes, a table has been prepared and presented as a folder opposite page 48, making a comparison of the leading and some other nations on this basis. The term Latin Union in this table embraces France, Italy, Belgium, Switzerland and Greece. This Union ceased to exist in 1920 but the name is retained here as the facts given pertain to an earlier period.

Those who have interested themselves in the project of an international coinage have pointed out that, with minor deviations, there are in effect represented in this table not more than two distinct money systems based respectively upon the shilling (approximately 25 cents) and the franc (approximately 20 cents).

This groups the franc and the Austrian kronen with the Dutch gulden which is substantially the double franc. It groups Germany and Scandinavia together with Russia, Mexico and Japan having a double shilling. The dollar appears as the multiple alike of the shilling and the franc, while the pound sterling is of course, the multiple of the shilling as well as of the franc. It is not to be wondered that, among those whose desire to remake the world is innate, these approximate relations should give rise to the dream of a pound that was exactly five times the dollar, and a dollar that should be exactly twice the yen and the rouble, two and a half times the gulden, four times the mark and five times the franc. Nor is there any doubt that if this could be brought about international financial relations would be greatly facilitated. Such approximate relations as now exist may be convenient for a rough and ready translation of one currency to another, but business is not done that way. It requires a more accurate calculation of these relations.

The theoretical relations of nations with another are regulated by the mint par. The actual relations are governed by the rates of exchange tempered by the cost of shipping gold. These three matters are intimately associated and should receive careful attention.

4. *Mint par of exchange.*—The mint par between any two countries is the value of the monetary unit of one country expressed in terms of the monetary unit of another country using the same metal as a

**TABLE OF GOLD CONTENTS AND EQUIVALENT VALUES OF THE MONETARY UNITS OF THE PRINCIPAL
GOLD STANDARD AND GOLD EXCHANGE STANDARD COUNTRIES.**

Country:	Unit:	Value of \$1:	Fineness:	Value in Dollars:	Value in Pence:	Grammes		Remarks:
						Standard:	Fine:	
Egypt_____	£E	£E 0.2023	875	\$4.9429	243.733	8.500	7.4375	_____
Turkey_____	£T	£T 0.2273	916%	4.3966	216.8	7.2164	6.615	_____
Great Britain_____	Sovereign	49.316d	916%	4.86656	240.	7.988055	7.32238	113 $\frac{1}{623}$ grains
Portugal_____	Escudo	E .9255	900	1.0805	53.284	1.80634	1.62571	_____
Uruguay_____	Peso	P .9669	917	1.0342	51.003	1.69717	1.55615	No gold coins minted
Newfoundland_____	Dollar	\$.9863	916%	1.0139	50.	1.66420	1.52551	_____
United States_____	Dollar	\$ 1.	900	1.	49.316	1.671813	1.50463	23.22 grains
Argentina_____	Peso	P 1.0365	900	.96476	47.58	1.6129	1.45161	45/31 grammes
Brazil_____	Milreis	1\$831	917	.54616	26.935	.89648	.82307	No gold coins minted
Brazil_____ (paper)	Milreis	3\$0822	916%	.32444	16.	.532537	.48816	1/15 of £1
Russia_____	Rouble	Р 1.9434	900	.51457	25.371	.86026	.774234	_____
Japan_____	Yen	Y 2.0062	900	.49846	24.582	.83333	.750	_____
Netherlands, The_____	Florin or Guilder }	ƒ 2.4878	900	.40196	19.823	.672	.6048	_____
Costa Rica_____	Colon	C 2.1489	900	.46535	22.951	.77801	.7002	No gold coins minted
India_____	Rupee	₹ 3.1.1	916%	.486	24.	.532537	.48816	1/10 of £1
Scandinavian Union_____	Krone	Kr 3.7315	900	.26799	13.216	.448023	.4032258	25/62 grammes
Germany_____	Mark	M 4.1979	900	.23821	11.748	.398248	.358423	100/279 grammes
Austria-Hungary_____	Krone	Kr 4.9352	900	.20263	9.993	.3387534	.304878	25/82 grammes
Latin Union_____	Franc	Fcs 5.18262	900	.19295	9.516	.3225806	.2903226	9/31 grammes

STATEMENT OF EQUIVALENT VALUES OF THE MONETARY UNITS OF VARIOUS COUNTRIES.

Country	Great Britain		North America	Holland	Scandinavian Union	Germany	Austria-Hungary	Latin Union
	Pounds	Pence	Dollars	Florins	Crowns	Marks	Crowns	Francs
Great Britain_____ £1. Stg.	1.	240.	4.866,563	12.107,110	18.159,515	20.429,46	24.017,426	25.221,54
Portugal_____ Escudo	.222,019	53.284,58	1.080,470	2.688,010	4.031,761	4.535,733	5.332,321	5.599,670
Uruguay_____ Peso	.212,518	51.004,38	1.034,233	2.572,990	3.858,223	4.341,631	5.104,140	5.360,039
North America_____ Dollar	.205,484	49.316,11	1.	2.487,816	3.731,485	4.197,922	4.935,192	5.182,621
Argentina_____ Peso	.198,243	47.578,34	.964,762	2.400,152	3.600,000	4.050,000	4.761,288	5.000,000
Brazil_____ Milreis	.112,228	26.934,77	.546,166	1.358,760	2.038,010	2.292,762	2.695,433	2.830,571
Russia_____ Rouble	.105,735	25.371,24	.514,567	1.280,148	1.918,100	2.160,113	2.539,488	2.666,806
Japan_____ Yen	.102,426	24.582,17	.498,461	1.240,079	1.860,000	2.092,500	2.460,000	2.583,333
Holland_____ Florin	.082,596	19.823,04	.401,960	1.	1.499,904	1.687,392	1.983,744	2.083,200
Chili_____ Peso	.075	18.	.364,992	.908,033	1.361,963	1.532,206	1.801,306	1.891,616
India (Br.)_____ Rupee	.066,666	16.	.324,438	.807,141	1.210,634	1.361,963	1.601,161	1.681,436
Scandinavian Union_____ Crown	.055,068	13.216,22	.267,990	.666,709	1.	1.125,000	1.322,581	1.388,889
Germany_____ Mark	.048,949	11.747,736	.238,213	.592,630	.888,889	1.	1.175,627	1.234,568
Austria-Hung'y_____ Crown	.041,636	9.992,76	.202,626	.504,097	.756,097	.850,610	1.	1.050,136
Latin Union_____ Franc	.039,649	9.515,69	.192,953	.480,080	.720,000	.810,000	.952,258	1.

Calculations based on 15.432,35 grains to the gramme.

standard of value, tho the degree of fineness of the metal need not be the same. All coins, whether of gold or silver, are made of so much pure metal and so much alloy; the latter is used to harden the coins, thus reducing abrasion to a minimum. The term "fineness" expresses the number of parts of pure gold or pure silver contained in a thousand parts of the combination. The British sovereign is 916 2-3 parts fine, or 11 parts fine gold and one part alloy. The gold coins of Turkey and Brazil are also 916 2-3 fine. Those of nearly all other countries are on a basis of 900 fine, or 9/10 fine gold and 1/10 alloy.

The mint par is arrived at by dividing the number of grains or grammes of fine gold in the one coin into the number contained in the other. For instance, compare the sovereign, the unit of Great Britain, and the gold dollar, the unit of the United States:

Gross weight of sovereign.....	123.27447 grs.
Less $\frac{1}{12}$ alloy.....	10.27287 grs.
Fine gold in sovereign.....	113.00160 grs.
Gross weight of dollar.....	25.8 grs.
Less $\frac{1}{10}$ alloy.....	2.58 grs.
Fine gold in dollar.....	23.22 grs.

therefore,

$$1 \text{ dollar} = \frac{23.22}{113.0016} = \text{£} .205484 = 49.316 \text{ pence}$$

$$1 \text{ sovereign} = \frac{113.0016}{23.22} = \$4.86656$$

Similarly, the gold franc contains .0589608 grammes of fine gold, while the dollar contains 1.50463 grammes. Hence,

$$1 \quad \text{dollar} = \frac{1.50463}{.0589608} = 25.52 \text{ fcs.}$$

$$1 \quad \text{franc} = \frac{.0589608}{1.50463} = 3.92 \text{ cents}$$

The mint par between any two countries can be arrived at in the same way. The mint par between two gold-using countries is constant. It varies only when one of them alters its coinage regulations by increasing or decreasing the quantity of pure metal in its monetary unit.

5. *Par of exchange*.—The mint par is the pivotal point of the rates of exchange between two countries. In other words, it is also the ratio at which the standard coin of the country will be exchanged for that of another. Theoretically, a sovereign is worth par in New York (\$4.86656), but practically this ratio holds good only for large amounts. If a traveler wants to change ten sovereigns in New York he would probably receive only \$48.50 or \$48.60 for them instead of \$48.66 $\frac{2}{3}$, the difference between retained by the bank as payment for its services and to cover the interest on the amount until it had collected sufficient sovereigns, say, one thousand, to warrant the trouble of taking them to the United States mint where they would be exchanged for \$4,866.56, less a small melting charge. If a few years ago the ten sovereigns were in London to the traveler's credit and this fact was properly attested he would probably have realized on them by selling to a New York bank the "right," in the form of a check or order, to draw these ten sov-

ereigns in London, and the New York bank would have paid him their equivalent computed according to the current rate of exchange. With an active demand for sterling exchange the seller would have obtained a good price for his check on London. If, on the other hand, there were little or no demand for sterling exchange and the supply of checks and bills of exchange was more than ample to meet the demand he would have obtained a low price.

It has already been pointed out that the mint par is merely the standard by which actual exchange rates are measured. They vary within narrow limits, fixed by the "gold points" or the cost of shipping gold. Exchange rates find concrete expression in the prices which prevail in the sale and purchase of bills of exchange.

6. *Rates of exchange.*—Bills of exchange are a commodity and as such are bought and sold, and like other commodities are subject to the law of supply and demand. The reader should, for the present, dismiss from his mind the thought that he is dealing in the money of foreign countries and should regard bills of exchange and other credit instruments, used in transferring funds, as representing a definite kind of commodity—evidences of indebtedness.

The rate of exchange is the price per foreign unit at which the right to collect these debts is sold and it does not refer, except indirectly, to the value of the gold monetary unit. A sovereign is always worth par in New York and the gold eagle always worth

par in London. When gold sterling is quoted at, say, \$4.85 in New York it does not mean that the sovereign has depreciated 1 2-3 cents below par; it means that the "right" to obtain a sovereign in London is worth only \$4.85 in New York. In this case the supply of these "rights" is ample and the demand small, hence the price falls.

7. *What makes the rate.*—The rates of exchange quoted between any two countries, therefore, are the prices for checks and bills of exchange. These are the mediums by which debts are transferred from one party to another.

The rate of exchange between two gold using countries charged by a bank or broker for a foreign bill of exchange includes:

- (a) The mint par or price equivalent of the foreign coin.
- (b) Plus or minus a premium or discount on the mint par (greater or less conversely to the supply of bills on the market as compared with the demand for them).
- (c) Plus a premium or commission which the banker demands for his trouble and for the economy and superior convenience of a draft as compared with a remittance in coin or bullion.
- (d) Less an allowance for interest, according to the distance between the two points, and the time therefore required for communications, and the tenor of the draft.
- (e) Plus the cost of shipping gold.

The rate of exchange paid by a bank or broker for a foreign bill of exchange includes:

- (a) The mint par.
- (b) Plus or minus a premium or discount on the mint par.
- (c) Less a commission covering the dealer's profit and an allowance for his risk and trouble.

- (d) Less a discount, according to the tenor of the draft.
- (e) Minus the cost of the shipping gold.

The mint par never varies. It is a constant factor in any exchange rate. The most frequent variations in the rates are found in the premium or discount on the mint par, the range of which is governed by the law of supply and demand and reflects the relative position of two countries as regards indebtedness. The allowance for interest or discount generally tends to vary with the foreign interest rate, tho sometimes in large transactions the domestic interest rate becomes a factor also, in connection with the financial operations necessary to complete them. The cost of shipping gold is influenced and at times offset by the mutations in the other factors.

8. *Coinage ratio*.—The rate of exchange, therefore, must not be confused with the ratio at which one country will exchange its money for the standard coins of another country. If a man has one thousand sovereigns in New York he will receive par for them, or \$4,866.56,¹ irrespective of the rate of exchange.

9. *Fluctuation in the rate of exchange*.—The in-

¹ The United States Mint will always pay for English sovereigns at the rate of \$18.949182 per ounce. 1,000 sovereigns weigh 123,247.47 grains (480 grains to the ounce Troy). Working this out, we get \$4,866.56 as the value of 1,000 sovereigns. As a matter of fact the United States Mint would pay the bank 90 per cent of this amount (\$4,380) on delivery and the balance ten days later, less a small charge of four cents per \$100 to cover melting expenses, thus the actual proceeds would be \$4,864.61.

Similarly the British Mint took gold eagles at £3:16:5½ per ounce, paying for them a fortnight after delivery without any charge. The Bank of England paid for them on delivery but made a small charge of about 1½d. per ounce to cover the interest for 14 days at 4 per cent.

intermediate rates between the gold points and the mint par, that is, the rates at which business is usually done, in addition to being affected by the supply and demand of bills between two places, rise and fall in sympathy with the influences at work on the other exchanges. London, for instance, while a debtor to New York, might be a creditor of Denmark, France or another country with which England has close exchange relations. If London drafts on these places were remitted to New York they would improve (i.e. raise) the rate of sterling exchange for the time being. If, however, the supply both of New York and Continental bills were to fall short, the point at which London would have to export gold would be soon reached.

10. *Rates tend to correspond.*—The rates of exchange between two or more places either correspond or tend to correspond. Thus, when a few years ago sterling exchange was at a discount in New York, say, at \$4.85, New York funds in London were at a premium; in other words, you could purchase in New York the right to obtain a sovereign in London for \$4.85, whereas for a sovereign in London you would only be able to obtain the right to \$4.85 in New York, a dollar costing 49.50d. instead of 49.316d., the par value.

Let us suppose that the rate in New York, in response to a demand for sterling, suddenly went to par, and a New York banker having heard from his London correspondent that New York funds were still at

\$4.85, cabled him to sell \$100,000 at that rate and as a result of this transaction the New York banker received a credit in London of £20,618.55. At the same time he sold his own draft at par against this amount in London. In actual practice he would have sold a draft of, say, £20,000, but for the sake of showing his profit let us presume that he sold a draft for £20,618.55. For this he received \$100,343.64 with which he paid the draft of \$100,000 drawn on him in London, and thus makes a profit of \$343.64 less cable charges and a small commission to the London banker.

By such processes the exchanges automatically regulate themselves between two or more places. It is obvious that under the influence of several such transactions marginal differences would rapidly disappear. The variations in the rates of exchange in the case cited are purposely exaggerated for the sake of illustration. In practice, a very slight difference in the rates will encourage these adjusting transactions, which are commonly known as arbitrage transactions.

11. *Gold points*.—Foreign exchange, thru the medium of bills of exchange and other credit instruments, enables countries to regulate their mutual indebtedness without the transfer of coin or bullion. A bill of exchange is a commodity like wheat and cotton, and, as such, it is subject to the law of supply and demand. If the purchase rate of exchange reaches the point at which it is cheaper to remit gold

than to pay the rate demanded for transfer by draft, gold exports usually result. The rates of exchange, produced by buying gold in one country and shipping it to another, are called the *gold or specie points*. The mint or theoretical par remains invariable among gold standard countries. If the exporting and importing of gold could be effected without expense or loss of interest, the mint par and gold points between any two countries would be practically identical, but heavy expenses for freight, insurance, cooperage, cartage, abrasion, interest while in transit and other charges are involved in a gold shipment. These expenses deducted from the mint par give the "import gold point" and added to the mint par give the "export gold point;" that is to say, if it should cost more to buy gold sterling exchange in New York than it would cost to buy gold to the same amount and ship it to London, the remitter naturally would take the cheaper method and export gold. On the other hand, when bills of exchange are so freely offered in New York that the rate becomes abnormally low, a seller, if he could obtain gold at par in London for his pounds there, would find it cheaper to transfer his London balance by importing the gold.

Under normal conditions, the cost of shipping sovereigns between London and New York is about two cents per sovereign, and the mint par of the pound sterling is \$4.86 2-3. Therefore, when a lower price than \$4.84½ was a few years ago offered for a bill of exchange it was cheaper to import the gold from

England, and when a higher price than \$4.881½ was asked, it was cheaper to send gold to England.

12. *Significance of gold movements.*—The export of gold from New York to London when gold is readily available in exchange for currency in both countries implies:

(a). That New York owes London (exchange is favorable to London and unfavorable to New York).

(b). That bills of exchange on London have been eagerly sought for in New York in order to liquidate this indebtedness.

(c). That the premium demand by sellers in the form of a higher exchange rate exceeds two cents per pound sterling and therefore it has become cheaper to buy gold in New York and export it to London.

Conversely, the import of gold to New York from London implies:

(a). That London owes New York (exchange is favorable to New York and unfavorable to London).

(b). That bills of exchange on London have been offered freely in New York to absorb this balance.

(c). That the discount demanded by buyers in the form of a lower exchange rate exceeds two cents per pound sterling and therefore it has become cheaper to buy gold in London and import it to New York.

13. *Actual gold points.*—Before the war, when all the countries concerned were on a gold basis, the extreme range of the gold points between New York and London, and the continental centers was approximately as follows:

	Imports	Par	Exports
New York and London....	\$ 4.84½	\$4.86 2/3	\$4.88½ per £1.
New York and Paris.....	5.23	5.18⅞	5.16 fcs. per \$1.
New York and Berlin.....	94.50	.95⅞	96.25 cents per 4 marks
London and Paris.....	25.32½	25.22	25.12½ fcs. per £1.
London and Berlin.....	20.53	20.43	20.34 mks. per £1.
London and Amsterdam...	12.15	12.10	12.04 florins per £1.

14. *Computing the gold point.*—Gold points are determined by the actual costs of shipping gold from one country to another and of making it available for monetary use in the country to which it is sent.

The charges for freight and insurance are readily comprehended. They have been in the last two decades fairly uniform and with improvements in transportation have tended to grow less. They may vary with unusual circumstances, as when the war forced all transportation and insurance charges upward. In August, 1914, for example, the United States could have shipped gold to Europe, only at great expense. In order to provide the necessary payments an arrangement was made by which gold was shipped to Ottawa, the Bank of England accepting payments in London on New York account against this deposit.

Another element is the charge for interest while the gold is in transit. This depends upon the rate of interest and the duration of transit. The improvement of ocean shipping has considerably diminished this charge. If as is generally the case the rate of interest in New York is higher than in London it would cost more to ship a given quantity of gold from New York to London than in the contrary direction. This among other things explains why the

upper and lower "gold points" are not as a rule equidistant from the mint par of exchange.

The more easily the foreign gold is made available for monetary use in the country in which it is received the smaller will be the divergence of the gold point from the mint par. Any obstructions placed upon this transfer will increase the divergence. Let us suppose for example, that all banks are under strict government supervision and are allowed to hold only domestic gold coin as reserve. The foreign gold must then be transformed into domestic coin before it can be used for monetary purposes. Coinage may be gratuitous, in which case there is no added expense except the loss of interest during the delay of manufacture into coin. This is added under such circumstances to the cost of shipping gold to that country. If, as not infrequently happens, there is a small charge say one fourth of one per cent to cover the costs of coinage, this too must be added to the cost of shipping gold.

15. *Gold shipments from New York.*—The following description of a shipment of \$1,000,000 in gold from New York to London is taken from Dean Joseph French Johnson's "Money and Currency" and will serve as an example of how a shipment of gold was made under normal conditions and will illustrate the many small factors which enter into the computation of costs.

During the last quarter of the nineteenth century the cost of shipping gold from New York to London fell from

three to two cents per pound sterling. The charges for freight and insurance both declined, while the increased speed of transatlantic liners reduced the loss on account of interest.

The following figures, showing the cost of shipping \$1,000,000 in gold from New York to London, were furnished by the representative of one of the largest New York banking houses:

Invested in fine bars, 23,220,000 gr. (48,375 oz.).....	\$1,000,000.00
Assay office premium on bars, 4 cents per \$100.....	400.00
Freight, 5/32 per cent.....	1,562.50
Insurance, 1/16 per cent.....	625.00
Packing and cartage.....	70.00

Total outlay.....	\$1,002,657.50
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The Bank of England's "price" of gold varies from 77s. 9½d. to 77s. 10½d. per ounce, English standard, 916⅔ fine. The mint coins an ounce of gold, English standard, into 77s. 10½d.; but the Bank of England, with which it is the custom of bullion owners to deal, usually pays a fraction less than this sum, thus saving itself from loss of interest while the bullion is being coined. It is assumed below that the bank pays 77s. 10d. per ounce.

48,375 oz. fine = 52,772.7 oz., 916 2/3 fine.

52,772.7 oz. @ 77s. 10d.....	£205,374
Deduct sundry expenses.....	4

Net receipts in London.....	£205,370
Cost of sovereign (1,092,657.50 ÷ 205,370).....	\$4.8822
Mint par in United States.....	4.8665

Cost of shipment per sovereign.....	\$.0157
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The reader will notice that no loss on account of interest is included in the foregoing. The New York banker who furnished the figures held that no such item was involved, for he sold sterling exchange as soon as he made a shipment, and so was never out of money in consequence. If we include interest for ten days at three per cent (\$835.54) we raise the cost of the shipment to \$.0197 per sovereign.

16. *Avoiding gold shipments.*—The principal object of exchange transactions is to avoid the transfer of money from place to place and the machinery of exchange operations is largely directed to that end. The early days of the War, with the increased risk and expense of transferring gold, gave rise to various expedients which may in modified form be adapted to peace conditions. The usual method was to deposit gold in the debtor country for account of the creditor country.

A part of the reserve gold of the federal reserve banks found safe repository for many months in the vaults of the Bank of England. The Bank of England accepted gold in Ottawa as equivalent to a shipment of gold to London. The Argentine Republic, Japan and other countries had gold deposited for their account in New York and London. Some more definite agreement along such lines among the financial interests seems to be a not unlikely future development which will avoid still further the costs of shipping gold.

17. *Reading the exchange rates.*—Within the limits fixed under normal conditions by the gold points, exchange varies. Formerly a man not directly connected with the business of foreign exchange was likely to have some difficulty in interpreting the exchange rates published in the newspapers. The method of quoting was not always obvious and persons unfamiliar with the mint parities on the basis of which actual exchange rates are to be judged found

themselves confronted with a puzzle. There has been in recent years considerable improvement in this respect. The increased interest in exchange conditions has led to a more intelligible presentation of the facts. Mint parities, which before the War were taken for granted, are now usually printed with the exchange rates, and the depreciation of the exchanges of many countries from their normal position is thus emphasized.

There are two ways in which exchange can be quoted, fixed and movable exchange. When exchange is fixed, the foreign unit is expressed in terms of the domestic unit. Thus, for example, if the price of a pound sterling were quoted at \$4.87, it would mean that this sum must be paid for each pound and that exchange would be above par. When on the other hand exchange is movable its price represents the amount of foreign money which can be purchased for a given quantity of domestic money. Thus the London quotations on dollars mean the number of dollars which can be purchased for one pound sterling. The par is $4.86 \frac{2}{3}$ dollars. When exchange in London is quoted at 4.88, dollars are relatively cheap and exchange is at a discount, but when it is quoted at 4.84, dollars are dear in London and at a premium. In other words in fixed exchange the rise or fall of the quoted price varies directly with the premium or discount but in movable exchange the rise or fall of the quoted price is inversely as the premium or discount.

18. *Exchange quotations.*—The newspapers sometimes give exchange quotations in two columns. The first column (b) gives the price offered by buyers and the other (s) gives the sellers' price; one expressing the demand and the other the supply. The first column gives the lowest quotations—the buyers naturally offer as low a price as possible, while the sellers try to obtain the highest price—but the real or trading quotation is generally somewhere between the two. Perhaps a more frequent form of market quotation is that which gives the high, low and closing points for the day. There are two classes of quotations: the posted rate, which is used principally for small amounts, and the actual or wholesale rate, used between bankers and brokers for large transactions. As a rule, however, the rate for very large transactions is a matter of individual negotiations owing to the frequent change in conditions during the day. Furthermore, the rates are seldom published in time to be of much use except to show the general trend of exchange.

The American method of quoting dollars and cents per foreign unit (fixed exchange) is so simple that it renders exchange quotations self-explanatory. Canadian foreign exchange quotations are governed by the New York exchange market and differ only to the extent of the premium or discount on New York funds in Canada.

This satisfactory condition has only recently been attained, as it dates from the early part of 1920.

Prior to that time a mixed system prevailed. London and Amsterdam were quoted in cents per pound sterling and per guilder. Berlin was quoted before the War in cents per 4 marks, but francs were quoted in francs per dollar. Incidentally it may be remarked that quotations on other points were infrequent in the financial papers of the pre-war period and in the early days of the war. Not until New York assumed a commanding position in the exchange market after the Armistice did they become a matter of regular record.

In the whole range of business mathematics nothing more confusing or awkward can be found than the former franc quotation. It was the only movable exchange rate among the quotations. It fluctuated by five-eighths of a centime and close quotations were based on the subtraction or addition of sixty-fourths of 1 per cent on the dollar amount. There was nothing scientific or practical about this method, and it undoubtedly enabled some unscrupulous dealers to take advantage of the uninitiated public. People who dealt only occasionally in French exchange were prone to overlook the rule "Buy high, sell low," and unconsciously compared competitive rates on the basis of fixed exchange—"Buy low, sell high, the better the bill, the higher the rate."

A broker for instance who offered to sell a draft on Paris for Fcs 10,000 at $5.18\frac{3}{4}$ would in many cases obtain the business against a quotation of $5.19\frac{3}{8}$. The latter price looked the higher to the

customer, but it was of course the better quotation by \$2.32 in this particular transaction. If the same customer were selling francs he would, with the same reasoning, prefer to sell at 5.19³/₈.

Quotations of exchange rates are now made officially and unofficially. Official quotations relating to the buying rate for cables on a large number of points are made daily by the Federal Reserve Bank of New York, certified to the Secretary of the Treasury, who makes them public under the provisions of the Tariff Act of 1922. The law provides:

In ascertaining such buying rate such Federal Reserve Bank may in its discretion (1) take into consideration the last ascertainable transactions and quotations whether direct or thru the exchange of other currencies, and (2) if there is no market buying rate for such cable transfers, calculate such rate from actual transactions and quotations in demand or time bills of exchange.

The quotations thus prepared are given in dollars and decimal fractions of a dollar to four places except when the value of foreign unit is so small, as were for example in 1923 the German and Polish marks and some other units, as to render as many as six decimals necessary.

Unofficial quotations in the daily press are slightly different in form as shadings of less than one cent are usually expressed as common fractions of a cent. For example on July 20, 1926, the Federal Reserve Bank of New York quoted London cables at noon as \$4 8651, while the commercial papers give as the

closing price for the day \$4.86^{17/32}. Moreover, the commercial quotations concern not merely cable transfers but other forms of exchange, closing prices on London on the day mentioned being:

Demand sterling	4.86 ^{1/32}
Cable transfers	4.86 ^{17/32}
Bills	
Grain 7 days	4.85 ^{25/32}
Commercial, sight	4.85 ^{29/32}
Documents for payment	
60 days against grain	4.81 ^{29/32}
Commercial 90 days	4.79 ^{29/32}
Commercial 60 days	4.81 ^{25/32}

We may now consider the practice of the London market in quoting exchange which differs considerably from that of New York. On European points, the United States, and Canada the system of movable exchange is used. Quotations give the amount of each foreign currency unit which can be purchased for one pound sterling. These are perhaps the more prominent exchanges and this difference in the method of quoting is one of the difficulties which confronts the American reader in understanding the exchange news in the English press or in English treatises upon the subject.

On the other hand Eastern exchange and exchange on most South American points is quoted upon the direct basis giving the cost in pence of the foreign unit. In other cases, when colonial dominions (Aus-

tralia and South Africa) or foreign countries (Peru) have the same monetary unit as Great Britain the usual method of quoting the rates is on the premium and discount basis described in a later section.

On the Paris Bourse exchange is quoted by the direct method, which gives the value of foreign units in French currency. The rate for sterling and dollars quotes the price of one unit, in francs; for other currencies quotations are based upon one hundred units. Since compared with the pound and the dollar these other units have relatively low values it is obvious that the quotation by 100 units permits a finer shading in values than could be given for individual units without more or less confusing decimal fractions.

Before the Great War Berlin was an important centre for exchange transactions. The Berlin Börse followed the same method as above noted in Paris, quoting the price in marks of the pound sterling and the dollar and of 100 of each of the other foreign units. The Dutch exchanges have always had a prominent place in the world's financial markets. They too follow in their quotations the method of direct exchanges. This system which commends itself by its simplicity and directness is therefore that of the most frequent application.

The range of quotations in the normal equivalents of foreign units exhibited in the following table shows an almost steady progression in value from about 18 cents to 53 cents, with only one exception, sterling with its larger unit worth \$4.866. Sterling

quotations range from 4.75 to 4.90, advancing by 5/100 of a cent per pound, or as it is called 5 points per pound. The other quotations advance by steps of .01 cent, or one cent per 100 units, thus 18.01, 18.02, 18.06 and so on. The last column shows the profit made on \$1,000 for every advance of .01 cent, the profit on 1,000 foreign units being, of course, 10 cents for each advance of .01 cent in the quotation.¹

Country	Unit	Par Value in Dollars	Ordinary Range	Profit per \$1,000
France	Franc	.039	3 to 5 cents	51.8 cents
Austria-Hungary	Crown	.203	20 to 22 "	49.2 "
Germany	Mark	.238	22 to 25 "	42. "
Scandinavian U.	Crown	.263	26 to 28 "	37.3 "
Holland	Florin	.402	39 to 41 "	24.9 "
Mexico	Silver Dollar	} fluctuating }	41 to 50 "	22. "
South America				
Asia				
Japan	Yen	.498	50 to 53 "	19. "
Russia	Rouble	.515	50 to 53 "	10. "
Great Britain	Pound	4.866	4.75 to 4.90	02. "

19. *Special forms of quotations.*—When foreign exchange is quoted in the home currency per foreign unit, it is called fixed exchange; for instance, exchange on London is quoted in New York in dollars and cents per pound sterling. The latter is the fixed basis. The value of the pound fluctuates in dollars and cents—the higher the quotation the higher the cost of the foreign unit.

When the rate is quoted in foreign currency per home unit it is called movable exchange; for instance, exchange on Paris is quoted in London in francs and centimes per pound. The fluctuation is expressed

¹ The best tables for general use are to be found in "Foreign Exchange Tables" by E. D. Davis, Minneapolis, and "Foreign Exchange Explained and Simplified" by Howard K. Brooks, Chicago. Both of these books cover the whole range of the foreign exchanges. For sterling, Hartfield's "Sterling Conversion Tables" is the most comprehensive.

in the foreign currency—the higher the quotation the lower the cost of the foreign unit.

The United States and Canada quote in fixed exchange (dollars and cents per foreign unit) tho for large transactions with France and some other countries movable exchange was formerly used almost exclusively. A homely illustration may make the difference between those two methods of quoting clearer. Sugar and other commodities, like fixed exchange, are sold at so many cents per pound, or per hundred pounds, and the higher the price quoted the less sugar (or foreign money) you will receive for a dollar and therefore the dearer the exchange.

Sugar, like movable exchange, is also sold at so many pounds for the dollar (as was the case with French exchange) and the more sugar (or francs) quoted for a dollar the cheaper the exchange.

Fixed exchange: cents per foreign unit. Rule, buy low, sell high, the better the bill the higher the rate.

Movable exchange: francs per dollar. Rule, buy high, sell low, the better the bill the lower the rate.

Rule for fixed exchange.—Buy low, sell high, the lower the rate the more foreign money received. The better the bill the higher the rate.

How many francs can be bought for \$1,000 when the rate is 3.92 cents per franc?

$$\$1,000 \div 3.92 = \text{Fcs } 25,510.20.$$

How much will drafts for the following named amounts cost?

$$\text{Fcs } 25,510.20 \text{ at } 3.92 \text{ cents} = 25,510.20 \times 3.92 = \$1,000.$$

$$\text{Mks } 4,000 \text{ at } 24 \text{ cents} = 4,000 \times .24 = \$960.$$

Rule for movable exchange.—Buy high, sell low, the

higher the rate the more foreign money received per dollar. The better the bill the lower the rate.

How many francs can be bought for \$900 when the rate is 25.5 per dollar?

$$25.5 \times 900 = \text{Fcs } 22,950.$$

What is the value of a draft on Paris for Fcs 5,000 when the rate is Fcs 25.5 per dollar?

$$5,000 \div 25.5 = \$196.08.$$

Where there are two or more countries which are fortunate enough to have a monetary unit of the same weight and fineness in gold they have no conversions to make, and do not require any exchange tables. Among these countries are the United States and Canada with the dollar in common, Great Britain and her colonies with the pound sterling, and the European countries with the franc or its equivalent. Fluctuations in exchange rates in these countries are quoted at either so much per cent discount or premium, or, as in the case of Paris or Italy, so many units per so many units, as 98 francs per 100 lire. In the former case, where the percentage is small under normal conditions, these rates correspond exactly, a premium in one country corresponding to the discount in the other country or vice versa. As the percentage in premium increases however, it is necessary to allow for a difference which becomes very marked as the rate increases. In the case of the United States and Canada, for instance, the normal range of the exchange does not exceed $1/16$ of 1 per cent, and a premium on New York funds in Canada of $1/16$ would mean that Canadian funds in New York would

be at $1/16$ discount. The discount corresponding to a premium of $1/4$ of 1 per cent, or twenty-five cents a hundred, would be .24938 per cent. Two per cent premium would correspond to a discount of 1.96078 per cent and 15 per cent premium to a discount of 13.04348 per cent. In other words 100 Canadian dollars in the United States would be worth 86.95652, and not, as might be supposed, \$85.¹

In periods of abnormal quotations the neglect to understand thoroly the above conditions might lead to loss in exchange transactions.

20. *Exchange tables*.—Exchange tables, like interest tables, are most convenient and useful tools, and tho formidable in appearance with their serried columns of figures, they are simple in operation and their compilation is merely a matter of multiplication. A book of exchange tables is really nothing more than a table of reciprocals and their multiples.

All exchange tables give the same information tho some give it in greater detail than others—the number of foreign units for so many dollars and the number of dollars for so many foreign units, at various rates. As an example, we will compile a brief franc table for

¹ The above can be put in the form of a problem. If you obtain 100 United States dollars for 115 Canadian, how much do 100 Canadian dollars cost? This resolves itself into the proportion sum.

$$115 : 100 :: 100 : X \quad \frac{100 \times 100}{115} = 86.96$$

or a discount of 13.04%.

A card compiled by Mr. Patterson, giving the premium and discount parities per \$100, is published by John W. Hartfield, Inc., New York.

the rate 3.92. This represents the value of a franc in cents and we must now find the value of one dollar by division, $\frac{1}{3.92} = 25.5102$ Fcs. We are now ready to compile our table as follows:

	<i>Rate 3.92 cents</i>	
	<i>Francs per Dollars</i>	<i>Dollars per Francs</i>
100	2,551.0204	3.92000
200	5,102.0408	7.84000
300	7,653.0612	11.76000
400	10,204.0816	15.68000
500	12,755.1020	19.60000
600	15,306.1224	23.42000
700	17,857.1428	27.34000
800	20,408.1632	31.36000
900	22,959.1836	35.28000

Suppose we wish to find the value of 5642 francs at the rate 3.92 cents to the franc. The operation becomes one of addition:

5000 francs =	\$196.000
600 francs =	23.420
40 francs =	1.568
2 francs =	.0784
	<hr/>
	\$221.0664

To obtain the value of \$5642 the process would be similar. Using the other column:

\$5,000 = 127,551.02 francs, etc., etc.

By continued multiplication of the top lines, this table can be extended indefinitely, but the above is sufficient to find the equivalent of any sum up to 1,000,000 francs or dollars.

Our next table would be at the rate of 19.25, and so on for every quotation that is likely to be required.

REVIEW

Explain what is meant by the gold standard of currency.

What is the mint par of exchange?

Explain the meaning of fluctuations of the actual rates of exchange from the mint par.

What determines the rates?

Why do rates of exchange tend to correspond?

What are the gold points? What is their significance and how are they computed?

How is exchange quoted? How do rates in fixed exchange differ from those in movable exchange?

What are exchange tables?

CHAPTER V

EXPORTS AND IMPORTS

1. *Payments for exports.*—As we have seen, the movement of merchandise is not the exclusive factor in the commercial relations of nations, which gives rise to transactions in foreign exchange but it is none the less the dominant element in the balance which has been studied. The transactions to which this merchandise movement gives rise are therefore worthy of especial attention. In the adjustment of commercial accounts, bills of exchange are drawn with documents attached. The chief of these documents is the bill of lading to which the others, consular certificates, insurance certificate and letter of hypothecation¹ are subsidiary.

The nature of these documents needs no detailed explanation here, however. They are specially prepared forms and are familiar objects to those engaged in foreign trade and shipping.

¹ A letter of hypothecation is a certificate attached to a documentary bill of exchange and signed by the drawer. It describes the nature of the shipment, etc., and states in effect (1) that the bill of lading is lodged as collateral security for the acceptance and payment of the draft; (2) that in case of dishonor the holder is authorized to dispose of the goods and apply the proceeds toward payment of the draft and the expenses incurred; (3) that the drawer holds himself liable for any deficiency, and agrees to pay same on demand. When an exporter sells a number of bills of exchange to a bank, a general, or blanket, hypothecation certificate is given to apply to any and all bills of exchange purchased from him

The method of using the commercial bill of exchange can be most conveniently explained by means of a concrete example. Suppose a cotton merchant in New Orleans had sold a quantity of cotton to a Liverpool firm against draft with documents attached. The merchant would draw a sixty days draft in duplicate for the amount of the invoiced goods, say £10,000, and take it, with the relative documents attached, to his banker in New Orleans, who would credit him with \$48,500 at the rate of the day which we will assume to have been \$4.85. The merchant would have sold his cotton, received his money and would be ready for a new transaction.

The New Orleans bank sent the original bill and documents to its London correspondent, the duplicates following by a subsequent steamer. What happened in London to the bill depends upon its nature and whether the documents were to be surrendered on payment or on written acceptance by the drawee. If the documents were to be delivered on acceptance, the bill would become a "clean" bill and could be discounted in the London discount market and the proceeds placed to the credit of the New Orleans bank. If the documents were deliverable on payment only, acceptance of the bill would be obtained, but the documents would remain attached to the bill until maturity, unless the acceptor took up the draft under a rebate of interest for the unexpired time.

In the case of an "acceptance" bill, the proceeds became available as soon as the bill could be accepted

and discounted. In the case of a "payment" bill the American banker could not count on having the amount available until the maturity of the bill, tho prepayment under rebate might have placed the funds to his credit long before that time. If the New Orleans bank had no London correspondent it would have sold the draft to its New York correspondent, who would remit it to London in due course. All obligations on such bills remain liable until payment.

2. *The place of the transaction.*—Paradoxical as it may seem it makes a considerable difference whether an American exporter sells in a foreign market or a foreign importer buys in the American market. In both cases an export of American goods follows, and in both cases there must be a payment from the foreign country to the United States. The difference arises from the fact that in the first instance the American merchant obtains a foreign price for his wares, that is one fixed in a foreign market and expressed in foreign money, while in the second case he obtains an American price fixed by his own market and expressed in dollars. The first case puts the burden, if any, of exchange fluctuations upon the seller, the second puts it on the buyer.

In the illustration given in the preceding paragraph, the price was fixed in London and this is the usual rule in the sale of cotton. Where the price is fixed depends in large measure on the higgling of the market, in other words on whether the seller is more

anxious to sell than the buyer is to buy or the contrary.

When the United States exported wheat before the war it had to adjust its prices to the world's markets, and wheat sold abroad was sold at a foreign price. The United States competed with other wheat producing countries in those world markets. But during the Great War we might say that the markets came to the United States and foreign demand competed directly with domestic demand. The enormous demand of the Allies for food stuffs had to be satisfied almost wholly by the United States and the nations of the world bought in American markets and paid American prices for what they bought.

Altho every shipment of goods to a foreign country involves foreign exchange the exporter need know nothing of the intricacies of the latter if payments are made in his own money. If he gets the price agreed upon he can afford to leave to his customer any consideration of how the money is brought together. It will readily be seen that transactions with foreign countries are greatly facilitated when exporter and importer deal in the terms of money with which they are familiar and in amounts that are perfectly definite.

Fifteen years ago London's ascendancy in the trade and finance of the world gave it this transcendent advantage over all competitors. It enjoyed this position by virtue of the fact that it was the center of the world's commerce, and it had acquired that position largely thru the fact that for generations it had main-

tained the integrity of its monetary system. While other currencies may have fluctuated in value the world knew that a given number of pounds sterling always meant the same weight of pure gold. The war shook the supremacy of London by bringing an inconvertible paper money in its train. The impairment of the currency was less and its fluctuations less violent than in the Continental countries and the trade position of Great Britain compared with them did not change. But in competition with the United States where the gold standard was maintained Britain labored under disadvantages.

America is less disposed than formerly to clear its foreign exchange transactions thru London. It demands more and more that they be settled in New York. That means that in the trade of the world the dollar is taking in part the place long occupied by the pound sterling, and that international obligations whether they are those of foreign governments or those of foreign traders are more frequently expressed in dollars than was formerly the case. Let us examine how this dollar exchange affects the payments made for American exports.

3. *Financing foreign exports by means of dollar credits.*—Many goods are exported against dollar credits opened with some New York bank, and the exporter has a simple dollar transaction on his hands. Since 1916 dollar credits have been issued in greater volume than ever before and will no doubt continue to be more largely used.

In the first instance the effort to establish dollar exchange was due to the desire to give trade with foreign countries as nearly the aspects of a domestic transaction as possible. The bankers of the United States have for a number of years been seeking to establish connections in foreign countries notably in South America with a view to familiarizing foreign dealers with dollar exchange. All these efforts were immensely stimulated by the war which threw foreign currencies into disorder.

The primary motive in establishing dollar credits and dollar transactions has been to avoid loss thru fluctuating exchange with foreign countries. Let us consider the case of an American exporter, say, Mr. Brown of Baltimore who has sold a bill of goods to a customer in Paris.

He advises the purchaser to arrange a credit in New York in dollars for the amount of the invoiced goods, to be paid on delivery of the bill of lading and relative documents. The buyer goes to his banker, specifies the amount and the terms of the credit required, and the banker writes or cables to his New York correspondent to open a credit for so many dollars in favor of Brown. In this credit are set forth the terms in which Brown is to be allowed to draw the money, and the various documents which are to accompany the drafts. In due course Brown is notified that the credit has been opened. Accordingly, he draws a draft on New York and deposits it in his local bank. The draft is paid within a few

days and, as far as Brown is concerned, the transaction is closed.

The New York bank having paid the draft and taken over the documents forwards them, debiting its Paris correspondent who opened the credit. If the customer of the Paris bank is of high financial standing the bank will probably turn over the documents to him at once, even before full payment is made. Otherwise the goods will be stored by the bank on their arrival and released when payment is received. This is purely a matter of arrangement between the Paris bank and its customer and does not concern the American exporter or banks. In pre-war days the Paris bank might have been unable to arrange a dollar credit on New York and so issued instead, a credit on London in pounds sterling against either time or demand drafts with documents attached. In either case the effect is to make the matter of granting credit one between the purchaser and the Paris bank, rather than between purchaser and seller. This relieves Mr. Brown of any anxiety as to the payment. But in the first case he draws against a dollar credit in New York which is a simpler operation involving less cost than drawing against a pound sterling credit in London.

4. *Dollar acceptances.*—Until the establishment of the federal reserve banks, American foreign trade had been financed chiefly thru the medium of letters of credit issued on London banks. Establishing a credit in London, and thereby providing an English

acceptance, was no reflection on the high standing of the New York banks; it was due to provisions of the National Bank Act, which prohibited national banks from doing an acceptance business. Furthermore, the absence of an open discount market in New York was another serious obstacle to the free movement of foreign credit. This inability to finance foreign trade, except thru London, was formerly a serious handicap to the United States in its exchange relations with other countries. Spain, for instance, could never settle in dollars for imports from the United States because her imports from that country were paid for by credits opened in London, and these in turn had to be utilized to pay for credits opened in London in favor of the United States.

In a report on "Bank Acceptances"¹ prepared ten years ago for the National Monetary Commission this feature was discussed as follows:

As a result of the inability of our banks to finance imports thru the acceptance of time bills, American importers are, then, made dependent to a large extent upon London, and are required to pay London a considerable annual tribute in the way of acceptance commissions. This practice not only adds to the importance of London and militates against the development of New York as a financial center, but it at the same time works serious injury to our export trade. Since time bills cannot be drawn on our banks from foreign points against shipments of goods to the United States, there are consequently in such foreign countries very few bills which can be purchased for remittance to the United States in payment for goods which

¹ Publications of the National Monetary Commission, Document 569.

have been bought here. In other words, under our present banking system our imports do not create a supply of exchange on New York, for example, which can be sold in foreign countries to those who have payments to make in New York. This means that our exporters are also, to their great disadvantage, made dependent upon London. It means that when they are shipping goods to South America and to the Orient they cannot, when they are subject to competition, advantageously bill them in United States dollars. They, naturally, do not care to value their goods in local currency—that is, in the money of the country to which the goods are going—so their only alternative is to value them in francs or marks or sterling, preferably the latter, owing to the distribution and extent of British trade, creating thruout the world, as it does under the English banking system, a fairly constant supply of and demand for exchange on London. When we come to bill our goods in sterling, however, it is at once seen that our exporters are obliged to take a risk of exchange, which is a serious handicap when competing with British exporters. Our exporters who are to receive payment for their goods in sterling must previously decide on what rate of exchange will make the transaction profitable. If, in an effort to safeguard themselves against a loss in exchange, they calculate on too low a rate for the ultimate conversion of their sterling into dollars, their prices become unfavorable compared to those made by British exporters and they lose the business. If they do not calculate on a sufficiently low rate they get the business but lose money on the transaction thru a loss in exchange.

The disadvantages to which this passage refers were those which prevailed at a time when gold freely circulated in the currencies of Great Britain, France and Germany. When that free circulation ceased dollar exchange proposed by him as a convenience became an absolute necessity.

Under the Federal Reserve Act, however, national banks are now permitted to accept drafts based on the importation or exportation of merchandise and upon certain kinds of domestic transactions. The federal reserve banks stand prepared to discount satisfactory paper created by this class of business. Under present conditions, the Paris bank, referred to in the preceding section, would have issued a letter of credit instructing its New York correspondent to accept Brown's sixty- or ninety-day bill against delivery of the document, which bill after acceptance could be discounted by Brown's bank or its New York correspondent at one of the federal reserve banks. In other words the procedure would have been exactly the same as in the London case, except that the New York and not the London discount market would have carried the bill until maturity.

The Federal Reserve Act has provided machinery for such discounting and the international financial world is making constantly increasing use of the facilities offered. It is too soon to express any opinion as to the degree of permanence New York will attain as an international acceptance market. Nothing is more sensitive to restrictive conditions than international credit—it must ebb and flow freely or go elsewhere. The federal reserve banks have largely created the acceptance market and do all they can to stimulate and stabilize it. It has been necessary, however, for them to hedge it about with certain restrictions.

5. *Export letters of credit.*—In some countries where banking facilities are undeveloped, it was often difficult for the foreign customer to obtain a letter of credit on New York or London, or even to make a dollar remittance. In financing exports to such countries a different system was necessary in order that the American exporter could obtain his money without awaiting remittance from abroad. This system was based on the fact that in such countries banking relations with London were more intimate than those with New York. Out of this fact grew a system of “export letters of credit” which were issued by an American banker without the intervention of a foreign bank. The service which they perform in financing exports can best be understood by a concrete example. We will suppose that Williams of Chicago had sold a shipment of machinery to a firm in Honduras, where in the absence of direct exchange facilities with New York, it would have been very difficult for the Honduras merchant to purchase a draft on New York. Under these circumstances Williams, who did not wish to wait until the remittance was received, would have gone to his banker with invoices, bills of lading and other documents and would have asked him for an export letter of credit. The shipment we will suppose was worth \$10,000 and against this the Chicago bank would have given Williams a letter of credit, authorizing him to draw at ninety days against its London correspondent for £1,800 or about 90 per cent of the amount of the in-

voice. This draft on London Williams would have sold in the exchange market in New York or Chicago, (letter of credit being his authorization.) In return he would have received the bulk of his money at the current rate of exchange for 90 day business. The documents would then be forwarded by the Chicago bank to his correspondent in Honduras who collects the whole amount \$10,000. This sum was remitted in pounds sterling to London to the credit of the Chicago banker. Before the 90 day draft originally drawn would have matured there would have been received in London more than sufficient funds to retire it and neither the Chicago bank or its London correspondent would have had to disburse any money. The transaction would have been closed by the payment to Williams by the Chicago banker of the difference of the amount of the draft and the remittance from Honduras less any charges. As an alternative the Chicago bank would itself have drawn the draft on its London correspondent for £1,800 and have turned over to the customer the proceeds in dollars. This would have secured a better rate and the customer would have been saved the trouble of exchange transactions.

Any country, or any point, which like London before the war has direct relations with almost every part of the world, becomes the natural clearing house between countries whose exchange transactions with each other are limited.

Under present conditions it is possible that the

transactions would not be carried on in this way. The American exporter might insist upon the payment in dollars. With growing banking relations between South American countries and the United States he could insist with more reason that the merchant in Honduras should establish credit in New York, since the latter would be in a much better position to do so than would have been the case a few years ago.

6. *Commercial letters of credit and importing.*—Merchants who import goods into a country can settle for them direct either by remittance or by accepting a draft drawn by the foreign merchant but such methods are now seldom followed except in the case of minor transactions. The employment of letters of credit as a medium of settlement for import goods offers greater advantages than any other method of payment both to the exporter and importer.

Altho of late public attention in the United States had been drawn rather to exports they are to a considerable and perhaps growing measure offset by imports, and the financing of such imports is a matter of great importance. Thru the use of commercial letters of credit, the importer of merchandise is able to buy goods on a cash basis in any part of the world, even tho the actual payment is deferred 60 or 90 days, which gives him a chance to dispose of the goods in the meantime. They insure for him a shipment of goods in the stipulated time, exactly as described in the credit. He is also able to order in advance goods to be manufactured according to his specifications and

requirements without prepayment in advance, the letter of credit being sufficient security for the exporter. Formerly the majority of letters of credit were issued on London but the recent war and the Federal Reserve Act have brought out dollar credits issued on New York into more general use, especially for South American business.

This is a growing business and will no doubt within a very short time become thoroly familiar to the American public. For a long time, however, such transactions were handled thru London and because this represents a somewhat more familiar relation and at the same time shows the part which a world exchange center bears in the financing of exports and imports to which it is not directly a party we may follow the history of a credit established in London.

7. *British acceptances under letters of credit.*—Before the Great War shook to its foundation the financial supremacy of London its bankers granted enormous credits thruout the world which took two forms—acceptances granted under letters of credit or finance bills. The following illustration will show the operation of an acceptance under a letter of credit. When a merchant in Holland, France, the United States or any other country wished to buy goods in other parts of the globe he generally obtained the credit from a London banker directly or thru a banker in his own country. In the latter case, he instructed the foreign merchants from whom he had made his purchases to draw on the London banker at so many

months sight. Let us take the case of a tea merchant in New York, Mr. Young, who had negotiated with Napier & Company, tea growers in Ceylon, for a consignment of tea. Napier & Company probably knew little or nothing about the financial standing of Young, and even if they had known it to be excellent they would not have been willing or able to wait for a remittance from New York for the shipment. Napier therefore asked him to arrange a credit in London for the amount of the invoice say £1,000. Young went to his bankers, the Bank of New York, and requested that they open up a credit in London in favor of Napier & Company against 90 day bills with documents attached. The Bank of New York then instructed Barclay's Bank, their London correspondent accordingly, and Young was furnished with a letter which he could send to Napier & Company stating that the credit had been opened in London at the terms set forth. On receipt of the letter Napier & Company filled the order and placed the tea on ship board receiving the bill of lading therefor. Napier & Company then drew a draft at 90 days sight for £1,000 and attaching the bill of lading, insurance policy, invoice, etc., thereto, took it to their banker, the Bank of Madras, Colombo, who purchased the bill from them at the current rate of the day on London. Thus Napier & Company obtained their money immediately. The Bank of Madras forwarded the draft and documents to its correspondent in London, The Bank of Commerce, who without delay presented

it to Barclay's Bank, the latter accepting it, retaining the bill of lading and other documents. Later they are forwarded to the Bank of New York which was thus enabled to obtain possession of the tea when it arrived and either store it for their customer Young, on account, or deliver it to him on a trust receipt until he finally pays for it.

8. *History of the draft in London.*—To return to the draft which had now become an accepted bill with first class names on it and had an international currency. It was salable in any country of the world because every country at that time found it necessary to remit constantly to London and every foreign bank had a London office or a London correspondent. The bill could have been held until maturity and the proceeds could have been placed to the credit of the Bank of Madras, but the usual course would have been for the latter to instruct its London agent, the Bank of Commerce, to discount the bill in the open market and place the proceeds to its credit. Or, the bill may have been remitted by the agent to another foreign center to settle some accounts there. In either case, the bill whenever returned to London at its maturity was paid to the holder on that date by Barclay's Bank altho in the meantime it may have been sold several times and passed thru one-half dozen hands.

Barclay's Bank depended upon the Bank of New York to provide funds to meet the bill at maturity and would not have issued the credit unless it had had

confidence in the Bank of New York. The Bank of New York in its turn had confidence in its customer's ability to reimburse it and of course it insured that the latter would provide the necessary funds for transmission to London in time to discharge the obligation.

9. *Position of the obligants on the bill.*—To sum up the results of the transaction:

(a) Young, the actual debtor, had the use of £1,000 for three months and yet he, himself, would probably have some difficulty in naming his actual creditor at any particular moment.

(b) Napier & Company in Colombo received their money as soon as the tea was delivered on ship board, tho as they had drawn the bill, they remain obligants until payment.

(c) The Bank of Madras bought the bill from Napier & Company and was only out of its money until the bill had reached London, was accepted, discounted and placed to the bank's credit. It, however, remained until the payment of the bill liable as its indorser.

(d) The Bank of Commerce advanced no money. It acted only as agent of the Bank of Madras in obtaining acceptance of the bill, selling it in the discount market and crediting the proceeds. Therefore, its name did not appear on the bill. For its services it received a commission.

(e) Barclay's Bank was primarily liable on the bill as its acceptor, but as the Bank of New York had to provide the fund for payment the bank advanced no money on the transaction, it merely made a small commission for the use of its money.

The above were all interested, directly or indirectly, in the bill, but not one of them advanced a single cent. The question still remains, "Who paid for the tea dur-

ing the three months currency of the bill?" The answer is: "Those firms which discounted and purchased the bill in the open discount market of London."

10. *The part London plays.*—In much the same way, merchants in every country of the world had been accustomed to arrange credits in London for every other country in the world and for every conceivable class of goods. At the outbreak of the war it was estimated by Mr. Lloyd George that British banks and acceptance houses were liable for over £350,000,000 of these acceptances, the greater part of which had been discounted on the London market. Altho British signatures were primarily liable for this huge amount, it was not really for their own account, for they looked to those on whose behalf they had accepted the bills, to provide the funds. The unprecedented demand for sterling exchange at the beginning of the war was due to the attempt on the part of foreign obligants to provide funds for the maturing liabilities incurred by the British banks for their account, and under their instructions. Exchange rates on London the world over rose far above the gold point. If Great Britain had insisted on these debts, it would have been impossible to obtain the necessary sterling funds except at a most ruinous figure. Even if the English banks could have met the acceptances as they matured out of their own funds, disgrace if not ruin would have befallen a number of the foreign banks. It was to protect this vicarious liability of the English banks that a moratorium was proclaimed and

there is no doubt that this wise step saved the neutral countries, indebted to London, both financial loss and worry. Mr. Lloyd George in referring to this class of notes says:

There was that amount of paper out with British signatures at that time. Most of that had been discounted. The cash had been found by British sources, and the failure was not due to the fact that Great Britain had not paid her creditors abroad. It was due entirely to the fact that those abroad did not pay Great Britain. I think that it is very important from the point of view of British credit, to have that thoroly understood, for when the "moratorium" came, and there appeared something like a failure of British credit, it was not a British failure at all. It was because we could not get remittances from other countries. We had already paid, but it was vital to the credit and good name of this country that these bits of paper, which are circulated thruout the globe, with British names upon them, with names that have been associated with British trade and commerce—it was vital to the good name and credit of this country, to its continuity of trade and its character, that they should not be dishonored. What really happened was that there was a complete cessation of credit, a breakdown of the exchanges. It was exactly as if a shell had broken an arch in an aqueduct, and there was a cessation of the flow that had been going on before, and what we had to do was temporarily to repair the arch so that the flow should continue.

Before the war the acceptances under such letters of credit were not, of course, confined to London, tho London was a dominant feature in such financing. They can also be drawn, and this was done to some extent, on other large financial centers such as New York and Paris.

11. *Dollar exchange*.—The relative position of New York and London has been greatly shifted by conditions growing out of the War. American markets no longer resort to London exchange because it is easier. Not only that but in trade with places outside of North America there has been a great increase in the number of transactions financed thru such bills of exchange in New York. International conditions during the War forced upon New York the rôle of the world's financial center. As a result a large part of the world's trade which had heretofore been expressed in terms of sterling came to be expressed in terms of dollars. In the years immediately following the War the financial disturbance of the European money markets thru the continued issue of paper money wrought further to the advantage of New York. By reason of the rôle which the United States played in international finance, and the enormous growth of American trade the discount market in New York was immeasurably increased. By 1926, it was evident, however, that London was making long strides toward regaining her share of the financing of international trade and many could be found to express the opinion that she would completely recover her former preeminence.

The factors which make for strength in the financial world of London and New York will be considered in a later chapter. At this point it may be remarked that there seems to be no reason why New York should not continue to finance American

trade and also share with London in general foreign exchanges if the present growth of the discount market continues. In his book on "Foreign Exchange" (1920), Mr. A. C. Whitaker says:

The one great factor upon which the development of New York as a foreign trade financing center depends is the maintenance there of a discount market capable of absorbing (that is buying) the great volume of bills implied in this development, AT DISCOUNT RATES WHICH WILL AVERAGE AS LOW AS THOSE OF THE OTHER CENTER PREPARED TO OFFER SUCH A SERVICE, NAMELY LONDON. Otherwise the advantage will remain with the sterling long bill, because exporters will get more out of these bills for their shipments in the long run.

12. *Exports and imports are complementary.*—In analyzing the phenomena of international exchange as well as any other economic force it is necessary to isolate for the purpose of discussion the different factors which enter into it. It should not, however, be forgotten that in the world of business they are intimately associated with one another and that one reacts upon the other. In the explanation of international exchange the impression is frequently given that exports and imports are fixed by entirely extraneous considerations and that the other elements of exchange enter into the problem mainly for the purpose of compensating the disparity which may exist between exports and imports.

While this is true in some measure it tends to obliterate the fact that there are compensating elements as between exports and imports wholly apart from

other considerations. The amounts of the exports and imports of a country depend not only upon home production and foreign needs but also are profoundly influenced by the relation of prices in different communities. If, for example, the trade current should be such that in a given year one country should receive considerable quantities of gold in payment for an excess of exports, this could not fail to have an effect upon the price levels. Prices would rise in the country receiving the gold and would fall in those which had lost it. As a result the latter on account of the high prices prevailing in the gold receiving country would be much less disposed to buy from it and consequently the latter's exports would diminish. On the other hand, the lowering of prices in the countries which had lost the gold would make them good places in which to buy. In consequence, the gold receiving country would increase its imports from those countries. Thus it will be seen that thru the medium of price changes there is always a tendency towards an equilibrium in the exports and imports themselves. The fact that gold shipments tend to bring about a dislocation of prices, which thru its influence on exports and imports drops away with the need of gold shipments, that it tends to an equilibrium in the shipment of merchandise, is set forth by Dean Johnson in his "Money and Currency" in the following statement:

The reader will notice that the movement of gold is the direct result of the differences in the price levels of Europe

and America, which represent differences in the value of gold. He must not suppose that the disparity of prices is so great as to attract the attention of the average man. Indeed, the average man is not in a position to detect it, for prices in the United States are quoted in dollars and cents, whereas in Europe they are quoted in sovereigns, francs, marks, etc. Nevertheless the prices, whatever the names used, show exactly the purchasing power of gold in the different countries. The large importer, or the arbitrageur dealing in stocks and bonds, has at his elbow tables of figures showing precisely the relation between American and European prices. When there is a slight advance in the American price of a good, without any corresponding advance in the European price, he at once knows what profit he can make by purchasing abroad and selling at home.

Variations in the rate of exchange are equivalent to changes in international price levels. A rise of sterling from \$4.8465 to \$4.8865 means a rise of almost 1 per cent in the cost to Americans of foreign goods, and it tends to lessen our imports just as would an actual rise in the prices of European goods. At the same time this rise of exchange from gold point to gold point is equivalent in foreign countries—or wherever sterling exchange is dealt in—to a fall of almost 1 per cent in the prices of all American goods, for the purchasing power of the sovereign in the United States rises from \$4.8465 to \$4.8865. Hence American exports are stimulated. A decline of exchange quotations, of course, produces opposite effects, encouraging imports into the United States and discouraging exports. When the money supply of the United States is relatively neither excessive nor deficient, the changes wrought in our foreign trade by the rise and fall of exchange quotations are usually sufficient to prevent any movement of gold. But if the money supply is excessive, so that prices of certain goods having an international market are above the price level in other countries, then our imports of goods and securities, despite the discour-

agement of rising exchange rates, continue in excess of our exports until an exportation of gold becomes profitable. On the other hand, if our money supply is relatively deficient, our exports will be stimulated until the large accumulation of sterling exchange forces the price down to the gold-import point.

All these forces work automatically. No man engaged in the transactions imagines that he is doing anything to correct the monetary situation of the world or to cause an importation or exportation of gold. Altho each person is seeking personal profit only, he inevitably contributes to the general result. Thus, as a result of the operations of men in different countries, each acting independently in his pursuit of profit, the rates of foreign exchange in each country are so adjusted that the value of gold in all tends to be the same, gold always moving from the country where prices are relatively high and toward the countries where prices are relatively low.

It thus appears that a country's balance of indebtedness is not determined by chance. If there were no international transactions in debts or securities, no movements of capital from country to country,—in short, no invisible trade between nations,—then the exports and imports of merchandise would balance except when an excess of gold in one country lifted the price level there and brought about an exportation of the yellow metal. The invisible elements in the foreign trade of nations complicate the subject, but introduce no new principles and lead to no new conclusion. The balance of trade, so far as visible goods are concerned, may be more or less fortuitous, depending upon the crops and upon variations in the productive capacity of a nation; but the whole foreign trade of a nation, by which is meant its imports and exports of goods and of debts, is subject to an immutable law. The exports of goods and debts always exactly equal the imports of goods and debts, except when a balance of indebtedness is created on one side or the other by differences in the value of gold in different countries.

This balance of indebtedness, it should be noted, is not the real cause of gold exports or imports, but is itself the effect of conditions which render imperative a readjustment of the gold holdings of nations.

REVIEW

Describe the commercial bill of exchange and its use.

What is meant by dollar credits? How are they used?

Describe dollar acceptances. Why were they not used in earlier days?

Explain export letters of credit.

How do letters of credit function in financing imports?

Describe the part played by the London Exchange market in financing imports before the Great War.

Why do exports and imports tend to compensate and thus check gold movements?

CHAPTER VI

COMMERCIAL LETTERS OF CREDIT

1. *Diversity in letters of credit.*—The foregoing chapter has illustrated the use of commercial letters of credit and has indicated their importance in financing the exports and imports of a nation. The exposition of the processes of international exchange would however be incomplete without a detailed consideration of the nature and form of these important documents.

The complete transaction as has been indicated in the preceding chapter involves four parties:

- (a) The credit applicant
- (b) The opening bank
- (c) The negotiating bank
- (d) The beneficiary.

This in itself makes it a sufficiently complicated matter but, since the duties and obligations assumed by each of the parties and the privileges which they derive from it differ according to circumstances, it will be understood that the arrangement is a highly flexible one.

Differences in documents and forms which serve different purposes are necessary to international

commerce, but differences in documents and forms intended to serve the same purpose tend to create confusion and uncertainty. The development of commercial letters of credit in the United States has been comparatively recent, and at the outset each of the banks engaging in the business produced its forms more or less independently of the others. Thru conferences of representatives of the principal banks concerned in the matter efforts have been made to standardize the various documents which the transactions require. So far as a reference to specific forms becomes necessary in this discussion it will be to those recommended by the Commercial Credit Conferences above mentioned.

2. *Credit application.*—Let us take the simple case in which an American importer seeks the aid of his bank to finance a specific purchase of goods abroad. He tells his banker exactly what the transaction is to be and asks him to accept for him the seller's drafts against the shipment of the goods. In so doing he must of course specify the name of the seller, the amount and value of the goods to be purchased, and the character of the drafts to be drawn against the shipment. This may be done by an informal letter of application and this was at one time the usual procedure in the United States. The use of a definite form of application however is much to be preferred since it insures that nothing essential to the contract

—APPLICATION FOR COMMERCIAL LETTER OF CREDIT

(Form Proposed by Commercial Credit Conference)

Date.....

.....
(opening bank)

.....
(address)

Dear Sirs:

I
We hereby request you to open and transmit by cable an irrevocable letter
of credit upon the following terms and conditions: mail authority to
pay
in favor offor a sum or sums
(beneficiary)

not exceeding a total ofavailable by
(amount in words)

drafts on.....(if on applicant, without recourse)
at
(tenor of drafts)

if accompanied by the following documents:

Full set of negotiable ocean bills of lading made
out to the order of.....Bank,
(opening bank)

Cross out Commercial invoice
documents Consular invoice
not Marine insurance policy or certificate
required. War risk insurance policy or certificate
Certificate of
Certificate of
.....

evidencing shipment from
to of % invoice cost of
(name of vessel)

C. I. F.
.....F. A. S.
(property)

.....
(place)

F.O.B. (vessel)

War risk
Marine insurance to be effected by me under blanket policy No.....
us

issued by.....
(name of insurance company.)
This credit is (not) to be confirmed by a correspondent bank.
Drafts must be drawn and presented, or negotiated, not later than.....
(expiration date)

I
We hereby agree to sign, and deliver to you, an agreement for such credit,
in the form now used by you, the provisions of which are agreed to as defining
your rights and my obligations. Each of the provisions on the back hereof, ex-
cept so far as otherwise expressly stated, is to be incorporated as part of the
credit.

Your very truly

is omitted, and that nothing is left uncertain. Such a form is reproduced on page 101.

An examination of the form reveals the full detail of the information which must be given if the transaction is to be properly safeguarded.

3. *Credit agreement.*—It will be noted that this form expresses the willingness of the applicant to sign the usual credit agreement. Had the application been made informally it would doubtless have contained in the request some of the essential features which this form relegates to the contract. Of these probably the most important is the engagement of the applicant to provide in one way or another, the bank which opens the credit with the funds necessary to meet at maturity the obligations which it may have assumed.

The contract agreement recommended by the Commercial Credit Conference is a long and tedious document in which the duties of the contracting parties are set forth in painstaking detail. The obvious purpose of the instrument is to safeguard the interests of the bank at every point and for every contingency.

4. *Granting the credit.*—Whether the bank will grant the application of our importer will depend upon his credit standing and also upon the nature of his request. There may be circumstances in which the transaction on the part of the bank will, upon acceptance of the drafts presented, be practically equivalent to a loan. This would be the case where the bank

agrees to assume the obligation of payment on a D/A (documentary acceptance) draft.

In such a case the applicant must establish his credit standing by supplying statements of financial condition and any other information for which the bank may call. After an importer has furnished his bank with all of the necessary information about his business, he should make arrangements for a line of credit.

If the undertaking of the applicant to place the bank in the necessary funds when needed at the maturity of the drafts is supported by adequate collateral it is obvious that there is no need of a searching credit analysis. An applicant who can provide such collateral is not confined to his own bank, but can seek accommodation elsewhere.

Somewhat similar would be the situation in case the transaction is to be effected in staple goods against D/P (documentary payment) drafts. In that case the goods which form the subject matter of the importation constitute the bank's collateral. They are consigned to the bank, and the documents are not released to the importer, until the latter has made provision for the payments of the drafts against them. It is not to be understood that in such circumstances the responsibility of the buyer is a matter of complete indifference, but merely that the same scrutiny is not necessary as when the credit is entirely unsecured. Again, if the goods are not staple or readily salable

the credit standing of the importer will necessarily play a larger rôle in determining the bank's decision.

5. *The letter of credit.*—In the simplest form of transaction the opening bank informs the beneficiary either directly or indirectly that, at the request of the importer, they have agreed to accept and pay the latter's drafts of the tenor stated in the letter, up to a certain amount if drawn before a certain time and growing out of the sale of the specified goods, when accompanied by the documents evidencing sale, shipment and insurance. This letter may be sent direct to the seller, or its contents may be cabled to him, or it may be given to the importer who will forward it with his order.

Armed with such a letter the seller is in a position to prepare his shipment and, having collected the necessary documents, attach them to his draft and take the latter to his bank to be discounted. This bank will carefully examine all the documents and ascertain whether the shipment has been made in exact accord with the instructions of the letter of credit, and the draft drawn in conformity with it. Finding this to be the case it will discount the bill and place the proceeds at the disposition of the seller. Sometimes it will require from the latter a written declaration that the terms of the letter of credit have been strictly observed in every respect. With the discounting of the bill of exchange the seller is out of the transaction except in so far as he has assumed a contingent

liability for the draft in case anything goes wrong.

6. *Varieties of letters of credit.*—The letter of credit was stated to be a very flexible instrument adapted to the most varied conditions of trade, and this will be seen by a consideration of some of the more important differences between them.

For purposes of illustration we have considered the letter of credit designed to facilitate a single transaction and have noted that it was definite in amount and was valid for a fixed period of time. When transactions are continuous other forms appear.

Thus a credit may be granted not to exceed a fixed sum which may be available as needed for a period of a year. Sometimes provision is made that the drafts drawn in any month shall not exceed a stated sum, and these sums shall be non-cumulative. In other words, if for example no drafts were drawn in the month of March, the sum allotted to that month would not be available for any succeeding period during the life of the letter. In other cases, even tho a monthly allotment may be provided, the credit is available for any unused portion of it up to the date of the draft.

Another form used in a similar situation is that of a revolving credit. This grants credit for a definite period in an aggregate amount, let us say, of \$50,000 at any one time. When this amount is outstanding no further drafts can be drawn against the credit. But as outstanding drafts are cancelled by payment,

new drafts can be issued until the limit specified in the letter has been reached.

7. *Revocable and irrevocable letters.*—The undertaking of the opening bank is to accept and pay any drafts drawn in conformity with the letter. If the letter is stated to be irrevocable the bank cannot withdraw from this engagement during the life of the letter. This is the most desirable form of letter of credit and is that customarily used for single shipments covering a comparatively short period of time.

There may be circumstances, however, in which the bank is unwilling to enter into such an engagement, particularly when the transaction or series of transactions are likely to extend over a considerable period of time. In such a case it may issue a revocable letter; in other words it reserves the right to withdraw from the arrangement, should it see fit, upon proper notification. The beneficiary must be informed in such a case that the letter no longer holds good. It is clear that such revocation cannot extinguish obligations already entered into or initiated in good faith by the beneficiary before the notification of revocation reaches him. It affects only the unexpired term of the original letter. Revocation can be made by cable.

8. *Notifying the beneficiary.*—The opening bank may, as we have seen, notify the beneficiary directly or it may leave this to the buyer. The latter will often request the bank to issue the notification and it very frequently prefers to do this indirectly thru

the medium of its correspondent bank. One advantage of so doing is that notice comes to the beneficiary from a source with which he is familiar. Another advantage of so doing is that it tends to throw the business of negotiating the draft, when drawn, into the hands of the notifying bank. It does not impose any obligation upon the beneficiary to transact his business with the correspondent bank, and he may "shop" around with his draft seeking the best obtainable terms.

On the other hand the opening bank may make the correspondent bank a direct party to the transactions. In such a case the opening bank requests the correspondent bank, now the advising bank, that it open a credit in favor of the beneficiary to meet all drafts drawn upon the advising bank. In giving notice to the beneficiary the advising bank may explain that it acts only as an intermediary and incurs no responsibility on its own behalf. A form of expression recommended by the Commercial Credit Conference reads:

This letter is solely an advice of credit opened by the —— Bank and conveys no engagement by us.

Such a letter is known as an "unconfirmed" letter.

In some cases the advising bank performs a more active rôle. It undertakes a specific guaranty that the drafts drawn upon it under the letter of credit will be duly honored and paid, and thus becomes, so

FORM.—CONFIRMED IRREVOCABLE
NEGOTIATION CREDIT

(Form Proposed by Commercial Credit
Conference—Form D.)

Credit No. D-b.....
.....19..
(city)

Dear Sirs:

We are instructed by Bank to advise you that
(correspondent bank)
they have opened their irrevocable credit in your favor for account of.....
for a sum or sums not exceeding a total of..... (figures)
..... (words)
available by your drafts on
at to be accompanied by
evidencing shipment of:

All drafts drawn under the credit must be marked:
"Drawn under Bank's
(advising bank)

Credit No. D-b....., dated 19.." (To be used when not all the documents are to accompany draft.)
There must be forwarded by early mail by the negotiating bank to
Bank, at the following documents:
(address)

remaining documents must accompany the draft.
The presentment of each draft, if negotiated, shall be a warranty by the negotiating bank that documents have been forwarded as herein required, and that the amount of each draft has been endorsed on the reverse hereof; otherwise, this credit and all relative documents must accompany the draft.
The credit must accompany any draft which exhausts the credit and must be surrendered concurrently with the payment of such draft.
Each of the provisions on the back hereof, except so far as otherwise expressly stated, is incorporated as part of this credit.
..... Bank engages with the drawers,
(correspondent bank)

endorsers and bona-fide holders of drafts drawn under and in compliance with the terms of this advice that the same shall be duly honored on due presentation and delivery of documents as specified, if negotiated, or presented at.....
:.....on or before 19.;
we confirm the credit and thereby undertake that drafts drawn and presented as above specified shall be duly honored.

Yours very truly,

FIGURE 2.

far as the beneficiary is concerned, a principal in the transaction. Such a letter is a confirmed letter of credit.

The relation of confirmation to revocability must be apparent with a little consideration. The agent will not assume a greater liability than the principal, and hence revocable letters of credit must always be unconfirmed. An irrevocable letter of credit may be confirmed or unconfirmed according to circumstances.

The form of confirmed irrevocable negotiation credit, printed on page 108 will serve to bring out the essential features of this, the highest class of letter of credit.

9. *Credit risk and mercantile risks.*—The banker who issues a letter of credit insures the parties concerned against the credit risk which it involves. His duty is completed if he sees that the documents have been prepared in accordance with the instructions, and it goes no further than that. It is not the banker's duty to inspect the goods shipped and see that they conform to the purchase order. He does not guarantee the good faith of the seller. Sometimes highly technical descriptions of the goods to be purchased have been inserted in the letter of credit, with the intent of making the banker responsible in the event of the goods shipped not conforming to specifications. The safest course for the banker in such a case is to refuse to grant the credit unless some modification of

the statement can be secured from the buyer which will relieve him of any possible responsibility.

In other words it is not the function of the banker to assume any of the mercantile risks which the transaction may involve. If the seller ships goods other than those ordered, or goods of inferior quality, the loss in the first instance must fall upon the buyer with such recourse as he may have against the seller. It can not be shifted to the bank, on the plea that the goods did not carry out the instructions of the letter of credit.

10. *How the banker is compensated.*—The operation of a letter of credit involves the discount process, which is entirely familiar, but it also involves the loan of the bank's credit. For this service a commission

APPLICATION FOR COMMERCIAL CREDIT

New York.....

GUARANTY TRUST COMPANY OF NEW YORK.

Dear Sirs,

Please issue for our account a Documentary

Credit in favor of

.....
for £.....drafts at.....
against.....cost of shipment of.....
from.....to.....
In force until first day of.....
Insurance effected in.....
Kindly advise the Credit by

CABLE

MAIL

Yours truly,

FIGURE 3.

Credit No.....
 £.....Sterling

GUARANTY TRUST COMPANY OF NEW YORK

New York.....19..

To the GUARANTY TRUST COMPANY OF NEW YORK,
 33 LOMBARD STREET,
 LONDON.

Gentlemen:

At the request and for account of.....
 we hereby authorize.....
 or any parties whose drafts you may be directed by...written order, or
 by us, to accept under this credit, to value on you at.....for any
 sum or sums not exceeding in all.....
 Pounds Sterling (say £.....Sterling) to be used as.....may
 direct for.....invoice cost of.....
 to be purchased for account of.....
 and to be shipped to a.....port in the United States.....

The Bills must be drawn in.....
prior to the first day of.....
 and advice thereof given to you in original and duplicate, such advice to
 be accompanied by Bill of Lading filled up to order of the Guaranty
 Trust Company of New York (with copy of invoice) for the property
 shipped as above.

All the Bills of Lading issued, except one sent to us by the vessel
 carrying the cargo, and one retained by the captain of the said vessel, are
 to be forwarded direct to you. Copy of invoice, properly certified by the
 U. S. Consul to be forwarded to us by the vessel, also advice of each Bill
 drawn.

And we hereby agree with the drawers, indorsers, and bona fide
 holders of Bills drawn under and in compliance with this credit, that the
 same shall be duly honored on presentation at your office in London.

We are, Gentlemen,

Your obedient servants,
 Guaranty Trust Company of New York,
 by

.....
 Manager.

N. B. Bills drawn under this credit must be marked Drawn
 under Guaranty Trust Company of New York
 Letter of Credit No.....dated.....
 for £.....

Insurance in order at.....

FIGURE 4.

New York,19...

To the

GUARANTY TRUST COMPANY OF NEW YORK

Gentlemen:

Having received from you the Letter of Credit of which a true copy is on the other side, ^I_{we} hereby agree to its terms, and in consideration thereof ^I_{we} agree with you to provide in New York, twelve days previous to the Maturity of the Bills drawn in virtue thereof, sufficient funds in cash, or in Bills on London, satisfactory to you, at not exceeding sixty days' sight, and indorsed by ^{me}, to meet the payment of the same withper cent commission and interest as hereinafter provided, and ^I_{we} undertake to insure at ^{my}_{our} expense, for your benefit, against risk of Fire or Sea, all property purchased or shipped pursuant to said Letter of Credit, in Companies satisfactory to you.

^I_{we} agree that the title to all property which shall be purchased or shipped under the said credit, the bills of lading thereof, the policies of insurance thereon and the whole of the proceeds thereof, shall be and remain in you until the payment of the bills referred to and of all sums that may be due or that become due on said bills or otherwise, and until the payment of any and all other indebtedness and liability now existing or now or hereafter created or incurred by ^{me}_{us} to you on any and all other transactions now or hereafter had with you, with authority to take possession of the same and to dispose thereof at your discretion for your reimbursement as aforesaid, at public or private sale, without demand or notice, and to charge all expenses, including commission for sale and guarantee.

Should the market value of said merchandise in New York, either before or after its arrival, fall so that the net proceeds thereof (all expenses, freight, duties, etc., being deducted) would be insufficient to cover your advances there against with commission and interest, ^I_{we} further agree to give you on demand any further security you may require, and in default thereof you shall be entitled to sell said merchandise forthwith, or to sell "to arrive," irrespective of the maturity of the acceptances under this Credit, ^I_{we} being held responsible to you for any deficit, which ^I_{we} bind and oblige ^{myself}_{ourselves} to pay you in cash on demand.

It is understood that in all payments made by ^{me}_{us} to you in the United States, the Pound Sterling shall be calculated at the current rate of exchange for Bankers Bills in New York on London, existing at the

time of settlement, and that interest shall be charged at the rate of five per cent per annum, or at the current Bank of England rate in London if above five per cent.

Should ^I_{we} anticipate the payment of any portion of the amount payable, interest is to be allowed at a rate of one per cent under the current Bank of England rate.

In case ^I_{we} should hereafter desire to have this credit confirmed, altered or extended by cable (which will be at ^{my}_{our} expense and risk), ^I_{we} hereby agree to hold you harmless and free from responsibility from errors in cabling, whether on the part of yourselves or your Agents, here or elsewhere, or on the part of the cable companies.

This obligation is to continue in force, and to be applicable to all transactions, notwithstanding any change in the composition of the firm or firms, parties to this contract or in the user of this credit, whether such change shall arise from the accession of one or more new partners, or from the death or secession of any partner or partners.

It is understood and agreed that if the documents representing the property for which the said Credit has been issued are surrendered under a trust receipt, collateral security satisfactory to the Company, such as stocks, bonds, warehouse receipts or other security, shall be given to the Company, to be held until the terms of the credit have been fully satisfied, and subject in every respect to the conditions of this agreement.

It is further understood and agreed in the event of any suspension, or failure, or assignment for the benefit of creditors on ^{my}_{our} part, or of the nonpayment at maturity of any acceptance made by ^{me}_{us}, or of the nonfulfilment of any obligation under said credit or under any other credit issued by the Guaranty Trust Company of New York on ^{my}_{our} account, or of any indebtedness or liability on ^{my}_{our} part to you, all obligations, acceptances, indebtedness and liabilities whatsoever shall thereupon, at your option then or thereafter exercised, without notice, mature and become due and payable.

FIGURE 5 (Continuation)

is charged of from $\frac{1}{8}$ to $\frac{1}{2}$ of one per cent. In the case of a confirmed credit an additional commission is required, in which of course the confirming bank shares.

11. *Sterling letter of credit.*—Before the World War the issue of dollar credits was comparatively

rare. Most of the international business was done on a sterling basis. A study of the documents in such a case, reproduced on pages 110 to 113, shows that the principal sum is stated in British currency. The New York bank operates thru a London correspondent, and agrees to place the latter in funds at the maturity of the drafts negotiated under the letter. The funds for this purpose must be furnished by the applicant, who on his part agrees to furnish London sight exchange ten days before maturity or London cables two days before the drafts fall due.

12. *Authority to purchase.*—Somewhat similar to the letter of credit is the “authority to purchase” sometimes called an “Oriental” or “Chinese” letter of credit, used in Eastern trade. The operation of these instruments is somewhat as follows: A Chinese importer, let us say, desires to buy goods in San Francisco and to accept the San Francisco dealer’s drafts against the shipment. The American exporter may, however, find it difficult to find a market for these drafts. This is accomplished thru the authority to purchase. The Chinese importer arranges with his bank that if the latter will negotiate the drafts he will supply the necessary funds to pay them. The Chinese bank then advises its San Francisco correspondent or agency to give the American exporter notice that it will negotiate his drafts. The drafts, however, do not have the bank as drawee, but are drawn directly upon the Chinese importer. The bank then

facilitates the negotiation of the drafts, but does not in any way change the ultimate contingent liability of the exporter as the drawer of the bills of exchange.

13. *Foreign and domestic credits.*—In this sketch of the characteristics of a letter of credit enough has been said to show its varied forms and various uses. It remains to consider chiefly a subsidiary use to which it may be put in financing domestic operations.

Let us assume that the beneficiary of the contract is not in possession of the goods ordered. They must be purchased by him or must be manufactured. For these operations he has not the necessary capital. In some cases he can take his letter of credit to the bank, and on that basis secure a subsidiary letter for a smaller amount in his own favor and thus be placed in a position to secure the goods required for the shipment. It is understood of course that the details of the operation are so arranged that the bank incurs no risk beyond that involved in the major transaction. In the case of goods to be manufactured the bank will of course be careful to see that the time required for their production does not exceed the time limit fixed by the letter of credit.

Subsidiary transactions of this nature may be repeated on the same original credit. In his work on "American Commercial Credits," Mr. W. Ward assumes the case of an impecunious coal broker who has

received from abroad an order for a quantity of coal at a favorable price. He shows how it would in such a case be possible, and for the bank a profitable operation, to use subsidiary credits, not only for the purchase of the coal by the broker, but also for the transportation of it to the point of shipment, and for the insurance premium upon it.

In some cases the beneficiary is the accredited buyer for the foreign merchant, and is called upon to assemble the goods for shipment. In such cases the letter may especially provide for advances to be made upon it.

The letter of credit thus reveals itself as a highly important instrument of foreign commerce, its principal function being to permit credit transactions by replacing the indefinite and perhaps unknown credit of the parties to the transactions with the definite and well known credit of officially established banks.

REVIEW

State the character and contents of an application for a letter of credit, and the considerations which lead the bank to grant or to refuse it.

Explain the different ways in which the beneficiary is notified of the issue of the credit.

Discuss the different forms which the credit may assume as respects the amount of credit granted.

Explain the difference between irrevocable and revocable letters, confirmed and unconfirmed letters.

Distinguish between the credit risk and the mercantile risk, and the relation of each to the bank's obligations.

What are the essential differences between a dollar credit and a sterling credit?

Describe the authority of purchase.

Explain some of the subsidiary uses of letters of credit.

CHAPTER VII

INVESTMENT

1. *International finance*.—Intimately associated with foreign trade in affecting the rates of exchange between nations is a group of operations which can be most conveniently designated as international finance.

The first phase to be considered here is the investment of one country in the funds and securities of another. This element in international exchange relations serves to equalize discrepancies in merchandise exports and imports over considerable periods of time, from year to year or decade to decade.

A second phase of international finance which is important in this connection is the growth of banking interests with wide-reaching international relations. By drawing upon each other by means of long bills, such as sixty day bills, designated as finance bills, these banks are able to dominate the exchange situation. The effect of these transactions is in large measure to neutralize divergencies in the demand for and supply of exchange from one season to another.

A third phase comprehends speculative transactions whether involving exchange itself, securities or gold, known as arbitrage operations, which serve to

equalize demand and supply in the exchange market from day to day.

All these relations of international finance to the exchange market must receive consideration.

2. *Investments*.—It must be understood that the exchange of goods between countries involves not only goods for immediate consumption, but represents frequently the transfer of capital from one country to another.

In the case of the receiving country, imports are not immediately offset by exports of goods. Instead, the sending country receives various evidences of indebtedness or ownership in the form of bonds, stocks, etc. Such a transfer of capital is characteristic of the trade of all civilized countries.

The effect of such capital investments upon the trade of a country may be considered. On the part of investing countries it first reveals itself in an excess of merchandise exports over imports, and in the country where the investment is made in an excess of merchandise imports over exports. On this excess of goods (capital) received, interest must be paid and eventually perhaps the capital must be reimbursed. If we assume the stream of investment to become frozen, the importing country must henceforth provide in its exports for interest and capital repayments. Hence its exports of goods must then exceed its imports.

A distinction should be made between the effects of bonds and of stocks as investments. Bonds are evidences of indebtedness. Their holders expect a fixed

annual return and eventually the repayment of capital as just indicated. On the other hand stocks are evidences of ownership of properties. Their holders desire to build up the values of the properties as well as to draw dividends. In consequence it frequently happens, especially in the case of new enterprises, that stockholders place their earnings abroad into the building up of their plants. So long as this practice continues, often for several years, the importing country is not called upon to provide in its exports for dividend and capital repayments. When that time does come, presumably the capital investment will itself earn more than enough to meet the obligation. Under these circumstances the effect of foreign investment in stocks upon the exchanges is, for the time being at least, not to increase the demand for imports, while largely increasing the exports.

But in the usual course of trade the stream does not freeze up after a single investment transaction has taken place. It is more likely to continue for a series of years. It is naturally the younger countries with undeveloped national resources and uncultivated economic opportunities which are the fields of such investment. In them capital is relatively scarce. It commands a relatively high return and is inadequate to the task of opening up all the sources of wealth which such countries contain. This high rate of return attracts investors in older lands where capital is plentiful and obtains a low rate of reward. The prospects of profits in American and Canadian rail-

roads, in Mexican mines, in Russian oil wells, in Brazilian coffee fields and rubber plantations, in Argentine cattle ranches, in South African gold fields and Australian sheep farms, have drawn from the careful investors of Western Europe notably in Great Britain and France, hundreds of millions, even billions, of dollars which have been invested in these and similar enterprises. And these investors have often waited for years before asking returns where stocks and other properties, rather than bonds, were bought.

Concerning the value and benefit of such investments Sir George Paish, perhaps the foremost authority on the subject, wrote in a report to the United States Monetary Commission as follows:

Most of the new countries are endowed by nature with almost unlimited natural wealth which can be made available for consumption by the expenditure of a relatively small amount of labor and of capital. In proportion to their natural resources the new countries possess but a small supply either of labor or of capital and they attract supplies of both from the older countries.

The construction of railways across fertile prairies opens up great tracts of virgin country to cultivation at a very small expenditure both of effort and of money. The rapid expansion of agriculture which ensues gives to the new countries a large amount of agricultural produce to exchange for the goods of the other lands and to pay interest upon the capital borrowed. The introduction of large sums of capital into the new countries for railways and other purposes causes, during the period of its introduction, large imports of manufactured goods into the countries borrowing the capital and as a consequence the imports of these countries largely exceed their exports. After a time the new countries increase their production of foodstuffs and

raw materials so largely that they are able to provide a much larger proportion of the capital they need for themselves and they obtain the goods they require from other countries to an increasing extent by exchange of their own production and less by capital borrowings. I calculate that capital wisely expended upon new railways thru districts containing fair agricultural and mineral resources brings about an annual production of wealth must more than equal to the total amount of capital spent upon the construction of the railways, a rate of production which could not possibly be secured if capital were not provided for railway construction. The capital needed for the direct development of agriculture, for mining, for house building, for manufactures, and for retail trade is chiefly provided by the inhabitants of the new countries themselves. Nevertheless, a portion of the capital required for these purposes is also provided by the older countries.

3. *Foreign investments in the United States.*—During the nineteenth century the United States offered the principal foreign field for the investors of Great Britain, and a few of the Continental countries. Apart from a loan of \$2,000,000 floated in London in 1836 by the Baltimore and Ohio Railroad, most of the investment of British and other European capital in the United States was, before 1850, placed in state and municipal bonds. But beginning in the fifties down to the middle of the eighties enormous amounts of foreign capital were absorbed in the development of the railway systems of the United States. More recently some of the larger industrial enterprises have drawn upon European markets for capital.

The rapid development of the wealth of the United States in the last generation has supplied from local

sources most of the capital needed for development of her enterprises. Investors in Europe in search of larger returns than the home market afforded have therefore turned their attention to other fields. For several years before the Great War there had been no very notable accretions of foreign investment in the United States, but the body of outstanding obligations inherited from earlier days was very large. The estimate for 1909, in the report before mentioned, is fuller and more complete than any other. It may be summarized as follows:

American Securities owned Abroad.

	Million Dollars
Great Britain	3,500
France	500
Germany	1,000
Holland	750
Belgium, Switzerland, etc.	250
	<hr/> 6,000

Such estimates are necessarily vague. Some of the elements which enter into the case are easily determinable, such as the first flotation of the securities in a foreign market. But the subsequent movement of such securities to and fro is necessarily shrouded in secrecy. Moreover, this movement consists as a rule of an indefinite number of comparatively small transactions whose aggregate it is difficult to estimate. It is not surprising therefore that the estimate above

given, tho generally accepted as authoritative by the financial press at the time it was made, should have awakened some dissent. Some excellent authorities, while admitting the impossibility of accurate determination, were inclined to the belief that the aggregate of European investment in American securities was nearer four billions of dollars than six billions.

4. *American investments in foreign countries.*—On the other side of the account should be placed investments of American capital in foreign countries. At that time these were confined largely to our immediate neighbors, Canada, Mexico and Cuba with lesser amounts in some South American countries. The report above cited estimated such investments in 1909 as amounting to one and a half billion dollars. Another estimate of the same period by Mr. C. F. Spear placed the total of these investments at two billion dollars, of which three-fourths had been placed in North and South American countries.

It is clear that a shifting in the balance of indebtedness in securities could occur thru the repurchase by Americans of American securities held abroad, thus reducing their obligations to other countries, and thru the purchase in the United States of securities issued by foreign nations, thus increasing their obligation to the United States. In fact the next few years saw both of these methods in operation.

5. *Return of American securities.*—All the evidence points to the fact that for a few years before the Great War there was a gradual decrease in Eu-

ropean holdings of American securities. This gradual return of such securities from foreign countries was immeasurably hastened by the developments of the war period.

With the outbreak of the Great War stock exchanges thruout the world were closed. The closing of the New York Exchange was a little later than that of the European exchanges and was dictated in part by the fear that American securities would be dumped upon New York in great quantities and the market broken. Trading on the Exchange was resumed earlier in New York than in the European financial centers. These conditions facilitated in some degree the disposal in the United States of American securities held abroad and it is possible that as a result the movement was slightly accelerated. There was, however, no very marked tendency of this nature until the British government took a hand in the situation.

As early as July 1915 the British government began what it termed the "mobilization" of American securities, but active measures were not taken until the winter of 1915-16. Under the arrangements thus made, the British government up to the year 1922, when its operations were discontinued, secured by purchase or by loan the control over about one and a half billion dollars of foreign securities which were used in various ways to bolster up the exchange rates.

6. *America lends to foreign nations.*—Part of

the pre-War debt which the United States owed to Europe was created by the fact that American interests issued securities and sold them oftentimes in pound sterling denominations in the London market. Another part of it rose thru the fact that European investors bought stocks and bonds, usually the latter, in the American markets and transferred their holdings to their home countries.

When the Great War transferred, at least for the time being, the world's financial leadership to New York analogous processes occurred. Foreign governments, municipalities and to some extent corporations issued their obligations in dollars and sold them in the New York market. To a certain extent American investors have also purchased abroad the obligations of foreign countries expressed sometimes in their own currency units, sometimes in sterling. The extent of this second phase of the matter is problematical. While at times the rate of exchange on London has favored the purchase of sterling securities, it is to be remembered that American investors as a whole are unfamiliar with any currency except dollars and, in view of the wealth of investment opportunity open to them at home, will naturally hesitate to stray into strange fields.

Much more definite information is available regarding foreign flotations, particularly since the Armistice. In the early days of the Great War, before the United States became a participant, it was called upon only in a limited degree to finance the needs

of neutral and belligerent powers. The most conspicuous of these flotations was the Anglo-French loan of \$500,000,000. At the time it was notable for its size but still more perhaps for the fact that two of the Great Powers united to make a foreign loan in a foreign currency.

With the entrance of the United States into the War, government advances to the Allied Powers took the place of bond issues to the American public. At the same time the intensity of the struggle and the overpowering demands of the American government for the support of the investing public put a stop to the financial aid sought by other governments thru the sale of their obligations upon the New York market.

7. *Flotation of foreign issues.*—Soon after the Armistice foreign governments, municipalities and corporations needing capital began to seek it in New York. The American public became familiarized with foreign securities and they became a regular feature of the money market reports. Thus the *Commercial and Financial Chronicle* in July, 1926, quoted prices on no less than 222 foreign bonds, for the greater part government and municipal issues, which had been issued in the United States in American currency values.

The Commercial and Financial Chronicle of New York publishes figures showing the amount of new capital sent abroad, giving its estimate of the total new flotations.

The figures follow:

NEW CAPITAL SENT TO FOREIGN COUNTRIES
(Millions of Dollars)

	1922	1924	1925	1926	1927
Government and Municipal					
Canadian	100	135	146	109	135
Other	383	571	645	514	777
Total	483	706	791	623	912
Corporate					
Canadian	50	98	112	203	262
Other Foreign	86	197	404	522	543
American Corporations doing business abroad	33				
Total	169	295	516	725	805
Total Government and Corporation	652	1,001	1,307	1,348	1,717

Without entering upon a detailed analysis of these figures their significance becomes apparent when they are contrasted with pre-war figures. One has only to compare the figures here given with the flotations of the years 1911-13 which, without excluding the item of refunding operations, averaged only 60 million dollars.

During the years 1911-13 the flotations of foreign securities in Great Britain averaged 463 millions of dollars. During the war of course, such operations came to a standstill but were resumed in 1919. The amount of such flotations in Great Britain in 1922 was said by the Guaranty Trust Company to be 276 million dollars or somewhat more than one-third of similar operations in the United States. The Federal Reserve Bank of New York has compiled figures

upon the same topic which confirm the preponderance of the United States over Great Britain in this matter. For the five years ending December 31, 1925 the total flotations of foreign securities in the United States amounted to 4,365 millions of dollars against 2,856 millions of dollars floated in Great Britain. During this period Great Britain exceeded the United States as a market for foreign securities only in the first half of 1923.

9. *Relation to the exchanges.*—Having traced the movement of investments in the United States with reference to foreign countries to the end of 1927 it remains to restate briefly the relation of such investments to foreign exchange.

When an American security, for example a railway bond, is sold in Europe it is the equivalent of an export of goods and like such an export it adds to the supply of exchange in New York. Conversely, of course, the repurchase of the same security by an American investor has the same effect as an import of merchandise and adds to the New York demand for exchange.

Taking up the case, so frequent of late, in which foreign securities are purchased in New York, the transaction has the same effect as the import of goods from abroad and thus adds to the demand for exchange. When foreigners begin to buy back their own securities in New York, the effect will be the same as if the United States had exported goods and the supply of exchange will be increased.

10. *International securities market.*—The effect

of transactions such as are described in this chapter is to create a body of international securities. They are as familiar on the stock exchanges of foreign lands as on those of the land of issue. The nominal value of American securities listed on the London Stock Exchange as far back as 1909 was, for example, upwards of nine billion dollars, and a considerable portion of this amount was owned in Great Britain. In like manner the foreign section of the New York Stock Exchange list is constantly growing.

Securities of all kinds are far more mobile than the property which in one way or another they represent. Investment in securities goes hand in hand with speculation in them. Speculation is no more separated from investment in international than in national markets. That it plays its part in equalizing the forces of demand and supply here as elsewhere will be seen in a subsequent chapter dealing with arbitrage.

REVIEW

What is meant in general terms by international finance?

Describe the effect of capital investments upon the balance of exports and imports of goods.

To what extent was the United States before the war indebted to European countries for capital investments?

Explain the processes by which the securities of one nation come into the possession of the citizens of other countries.

What has been the rôle of the United States since the Armistice in supplying capital to other countries?

State the relation of transactions in securities to the exchange market.

CHAPTER VIII

FINANCE BILLS

1. *Definition of a finance bill.*—A long bill of exchange drawn by a banker or financial house in one country on a banker in another against securities in the hands of the latter is generally called a “finance bill.” The privilege of drawing such bills enables bankers to anticipate a change in the rate of exchange and also to tide over a period of high exchange which otherwise would necessitate a shipment of gold. When properly used it is an important factor in international exchange and serves not only as a cheap and efficient corrective to high rates, but aids in the development of the production and trade of the world by rendering credit more fluid and leveling money rates.

There is a wide diversity in the definitions which are given of a finance bill. Franklin Escher defines it as “an unsecured long bill of exchange drawn by a banker in one country on a banker in another country and sold for the purpose of raising money.” Other authorities are inclined to include all long bills originating between bankers, whether secured or not. The latter is perhaps the more general understanding of the term and the following definition is suggested as comprehensive:

A finance bill is a long bill of exchange, secured or otherwise, drawn by a banker in one country on a banker in another, the funds for the payment of which at maturity must be provided by the drawer.

When a New York banker had a satisfactory drawing arrangement with his London correspondents he was more or less independent of market conditions, and even if there was a scarcity of commercial bills on the market, he was in a position to create a supply of bills at a stated price. He was reasonably sure that he would be able to buy exchange at a lower figure to meet his obligations before their maturity, as a high rate of exchange brings out a large supply of finance bills resulting in a lowering of the rate. Mr. George Clare in his book on "Foreign Exchange" says, "The bidding need only be raised a centime or two to tap an almost inexhaustible source of supply—that of bankers' drafts." In other words, if the remitter cannot obtain a ready-made bill, he need only pay a little more and have one made to order.

2. *Finance bill for New York account.*—The most common occasion for the use of finance bills is to anticipate a fall in the exchange rates. For instance, under normal conditions, during the summer months, the rate of exchange for sterling is generally high in New York. It drops gradually until the fall, when large shipments of cotton and wheat result in heavy offerings of sterling exchange. Before drawing a finance bill, it is necessary for the New York banker to make arrangements with the accepting

bank in London as to the amount, terms, etc., of the accommodations. Such arrangements are general, applying to a series of transactions, or specific, applying to a single transaction only. Suppose the rate at the end of August some years ago was 4.88 for demand bills, and a banker, A, desirous of anticipating the probable drop in exchange in the fall, had arranged with his London correspondent, B, against securities deposited with him, for a credit of £10,000 by way of a sixty-day draft on London. A would draw a draft on B at sixty days for £10,000, which he could either (1) sell in New York at the sixty-day rate for bills or else (2) send to London to be discounted and placed to his credit there, and then sell his own sight drafts against this credit. In either case, he would have the use of the proceeds in New York until the maturity of the bill, when he must be prepared to place funds with B to meet it.

3. *Method of using finance bills.*—It will be noticed that B did not advance any money; he lent his name to A and the London discount market provided the funds. The advantages and disadvantages of this procedure may be summed up in illustrations:

1. A would sell his sixty-day bill in New York if he could obtain \$4.8523 per pound sterling or better. This rate is arrived at as follows:

Demand rate for sterling.....	488.
¹ Less, 63 days' interest at 3% (being the London market rate for prime bankers' bills).....	2.527

¹ Prior to the war, interest and stamps used to be calculated on the basis of \$485 to the £100, but owing to the wide fluctuation they are now frequently calculated on the actual rate itself.

Stamps 1/20 of 1%.....	.244	2.771
	<hr/>	<hr/>
Per £100.....		485,229
or \$4.8523 per pound sterling.		
The sixty-days bills for £10,000 should therefore net him.....		\$48,522.90
A employed these funds in New York for sixty days at 4%, earning		323.49
		<hr/>
		\$48,866.39
Seven days before the bill matured A purchased a demand draft for £10,000 which he forwarded to London to provide for the payment of the bill. By this time exchange had fallen as he anticipated and was at 4.85, so that he was able to buy the covering draft for.....		48,500.00
		<hr/>
A's profit (from which must be deducted B's commission of probably $\frac{1}{8}$ of 1%) was therefore.....	\$	366.39
		<hr/>

There is, of course, the risk that exchange might not fall at the end of October as anticipated, or that the interest rates in New York might not be maintained above 3 per cent.

2. If A sent the sixty-day bill to London and immediately sold a demand draft against the remittance, the transaction would work out as follows:

Amount of 60-days draft.....		£10,000.00
Less interest at 3%.....	£51.781	
Less stamps, 1/20 of 1%.....	5.00	56.78
	<hr/>	<hr/>
Net proceeds in London.....	£	9,943.22

A would thus be in a position to sell his demand draft for the above amount and provide himself with funds in New York, £9,943.22 at \$4.88=\$48,522.90, the same amount as realized in (1) by the sale of the sixty-days bills itself in New York.

The net proceeds, £9,943.22, are taken as the amount of the demand draft for illustrative purposes; in actual practice the draft would have been drawn in

round figures, £10,000. The same result would be obtained, thus:

£10,000 demand draft realized in New York.....	\$48,800.00
From which must be deducted the London charges for interest and stamps, £56.78 at \$4.88.....	277.09
	<hr/> \$48,522.91

If, at the maturity of a finance bill, it was not convenient to collect and remit the relative loan, it was generally possible to provide the necessary funds to meet the maturing bill by the sale of another bill.

4. *Loan of a finance bill.*—The last example shows that the New York banker assumed the risk of there being a rise in the rate of exchange before the transaction had been completed and the acceptance in London retired by a sterling remittance.

So far as the actual borrower was aware, the loan is an ordinary loan in American currency; he had no means of knowing that there is any question of foreign exchange connected with the transaction. He has borrowed say \$50,000 at two months at 4 per cent, but with his bank the case is different. It loaned the proceeds of a sixty-day bill on London and at its maturity would have to purchase a demand bill or cable for £10,000 at the current rate of exchange. The price paid for the bill determines the gain or loss in the transaction. If exchange rates went down as anticipated a good profit on the transaction might be made, but if the rate rose, the price to be paid might mean an even break because of the wiping out of all profit, or if the rate went high enough, an actual loss.

Bank A could eliminate this risk by loaning the bill of exchange instead of the dollar proceeds, and charging a commission instead of a fixed rate of interest; the borrower thus assuming the risk of a rise in the exchange rate. The borrower in this case, instead of receiving a loan of \$50,000, would be handed A's sixty-day draft on London for £10,000. This, he would immediately sell for dollars, but when the time for repayment came, he would have to pay back not dollars but a demand draft for £10,000 which he would have to purchase at the current rate of exchange. The banker makes a commission of about one-half of one per cent for sixty days and runs no risk in the matter other than the loaning risk to his customer.

5. *A finance bill on London account.*—Another form of finance bill was created when a London banker, desirous of taking advantage of a high rate of interest in New York, instructed his correspondent to draw on him for £10,000 at sixty days and lend the proceeds on the New York market. This the New York banker did and sold the bill in New York, investing the money. Neither banker employed his own money in the operation, the money being provided by the London market where the bill was discounted. At the maturity of the loan, the London bank was placed in funds to meet its acceptance by the New York banker, or if conditions continued favorable the amount might be either renewed or re-loaned in New York. A transaction of this nature

may have been entirely on the account of and at the risk of the London banker, or it may have been on joint account, in which case both the risk and the profit were shared.

6. *Other uses of finance bills.*—Finance bills, both secured and unsecured, may be drawn regardless of the conditions of interest or exchange, purely for the sake of raising money. As a rule, finance bills have a reasonable excuse for their existence. It may be objected that this is a way of getting money which might be easily abused, but in practice this does not happen. The London market is, at all times, uncannily in touch with the position of both the drawer and acceptor and any attempt on the part of either to issue this class of bill beyond what he is legitimately entitled to on the basis of his business or financial standing, is promptly nipped in the bud, first, by demanding higher rates and finally, by refusing to take the paper. Either action is, of course, detrimental to the credit of the party concerned, and bankers and others who operate in finance bills are most careful to leave a large margin for safety in their use of the very sensitive discount market. It is plain from the above explanations that when many of these finance bills are drawn on London they will have a tendency to lower the rate of exchange by increasing the supply of sterling bills on the market.

In these illustrations, London and New York have been referred to under normal conditions; finance

bills, of course, obtain between other countries but to a much less degree.

7. *Forward exchange*.—Operations in “forward exchange” have several points in common with finance bills; both anticipate fluctuations in the rate of exchange and both involve a large element of risk. In its simpler and more commercial form, forward exchange or “futures,” as it is sometimes called, is a term used to express the buying or selling of foreign exchange for future delivery. For instance, in July, a manufacturer in Canada accepts an order for goods to be manufactured and shipped to England before October 15. Knowing from experience that a change in the rate of exchange in October might make serious inroads into his profits, he asks his bank to quote him a rate for the amount of his shipment, and contracts to deliver the bills of exchange to the bank in October. In this way the rate is definitely fixed, and the risk of a falling rate is eliminated.

The bank can protect itself in two ways; by selling its own bills to fall due in October in London, or by selling London exchange for future delivery. As far as the obligation is concerned both cases amount to the same thing, except that in the latter no money transaction is involved. The decision of the bank is governed by the rate of interest obtaining in London in July. It is obvious that dealing in forward exchange is not necessarily based on an actual prospective transaction.

Franklin Escher, in his book, “The Elements of

Foreign Exchange," in reference to the making of money in dealing in "futures," says:

As a means of making—or of losing—money, in the foreign exchange business, dealing in contracts for the future delivery of exchange has, perhaps, no equal. And yet trading in futures is by no means necessarily speculation. There are at least two broad classes of legitimate operation in which the buying and selling of contracts of exchange for future delivery plays a vital part.

Take the case of a banker who has bought and remitted to his foreign correspondent a miscellaneous lot of foreign exchange made up to the extent of one-half, perhaps, of commercial long bills with documents deliverable only on "payment" of the draft. That means that if the whole batch of exchange amounted to £50,000, £25,000 of it might not become an available balance on the other side for a good while after it had arrived there—not until the parties on whom the "payment" bills were drawn chose to pay them off under rebate. The exchange rate, in the meantime, might do almost anything, and the remitting banker might, at the end of thirty or forty-five days, find himself with a balance abroad on which he could sell his checks only at very low rates.

To protect himself in such a case the banker would, at the time he sent over the commercial exchange, sell his own demand drafts for future delivery. Suppose that he had sent over \$25,000 of commercial "payment" bills. Unable to tell exactly when the proceeds would become available, the banker buying the bills would, nevertheless, presumably have had experience with bills of the same name before, and would be able to form a pretty accurate estimate as to when the drawees would be likely to "take them up" under rebate. It would be reasonably safe, for instance, for the banker to sell futures as follows: £5,000 deliverable in fifteen days, £10,000 deliverable in thirty days, £10,000 deliverable in forty-five to sixty days. Such drafts on being presented could in all probability

be taken care of out of the prepayments on the commercial bills.

By figuring with judgment, foreign exchange bankers are often able to make substantial profits on operations of this kind. An exchange broker comes in and offers a banker here a lot of good "payment" commercial bills. The banker finds that he can sell his own draft for delivery at about the time the commercial drafts are apt to be paid under rebate, at a price which means a good net profit. The operation ties up capital, it is true, but is practically without risk. Not infrequently good commercial "payment" bills can be bought at such a price and bankers' futures sold against them at such a price that there is a substantial profit to be made.

The other operation is the sale of bankers' futures, not against remittances of actual commercial exchange but against exporters' futures. Exporters of merchandise frequently quote prices to customers abroad for shipment to be made in some following month, to establish which fixed price the exporter has to fix a rate of exchange definitely with some banker. "I am going to ship so-and-so, so many tubs of lard next May," says the exporter to the banker, "the drafts against them will amount to so-and-so much. What rate will you pay me for them—delivery next May?"

The banker knows he can sell his own draft for May delivery at, say, 4.87. He bids the exporter $4.86\frac{1}{2}$ for his lard bills, and gets the contract. Without any risk and without tying up a dollar of capital the banker has made one-half cent per pound sterling on the whole amount of the shipment. In May, the lard bills will come in to him, and he will pay for them at a rate of $4.86\frac{1}{2}$, turning around and delivering his own draft against 4.87.

Selling futures against futures is not the easiest form of foreign exchange business to put thru, but when a house has a large number of commercial exporters among its clients there are generally to be found among them some who want to sell their exchange for future delivery. As to the buyer of the banker's "future," such a buyer might

be, for instance, another banker who had sold finance bills and wanted to limit the cost of "covering" them.

The foregoing examples of dealing in futures are merely examples of how futures may figure in every-day exchange transactions. Like operations in exchange arbitrage, there is no limit to the number of kinds of business in which "futures" may figure. They are a much abused institution, but are a vital factor in modern methods of transacting foreign exchange business.

REVIEW

What is a finance bill?

Show, by an illustration, what arrangements a New York banker makes with a London bank before drawing a finance bill.

Give an example of how a finance bill on London account is created.

How does the London market prevent either a drawer or an acceptor of finance bills from issuing them beyond the amount to which they are legitimately entitled?

Describe an operation in forward exchange.

CHAPTER IX

ARBITRAGE

1. *What is arbitrage?*—Arbitrage, or as it is sometimes called, indirect exchange, is a term applied to any transaction which takes advantage of differences of prices for the same article in different markets. Arbitrage is thus defined in Century Dictionary: "The calculation of the relative value, at the same time at two or more places of stocks, bonds or funds of any sort, including exchange, with a view to taking advantage of favorable circumstances or differences in payments or other transactions." This definition should include gold and, in a general sense, any other commodity. Wheat, for example, may be sold from one place where it is relatively cheap to another where it is relatively dear; this is arbitraging in wheat.

2. *When arbitrage is transacted.*—Arbitrage transactions are confined entirely to large financial centers, such as London, New York and Paris. The work calls for expert knowledge and a close study of financial conditions, as it is essential that the arbitrageur keep in daily, if not hourly, touch with his foreign correspondents, in order that they may be prepared to carry out a transaction without delay.

A recent article in a New York journal says:

In conducting such operations it is essential that the banker shall be advised, thru the cable, of the varying conditions of the markets abroad. In such markets as Paris and London, where the exchange transactions are always large, rates often fluctuate sharply and conditions change frequently. Consequently, tho the situation may be favorable one day it may suddenly become adverse, necessitating some modification of the method of arbitrating. Moreover, it frequently happens that after a successful negotiation has been effected by a banker as the result of private information, his competitors may be advised of the favorable conditions prevailing and they also may draw in a similar manner. Hence each operator seeks to obtain for himself alone all possible information regarding changes which are likely to affect his business. Sometimes a banker may find, upon calculation, that it will be profitable to conduct arbitrating of exchange between three or more points; in such cases the conditions at each of the points must first be ascertained and calculations have to be made with the utmost care. Occasionally in drawing bills the banker, in order to take advantage of arbitrating operations, will transfer credits, thru the cable, from an adverse center to a point favorable for his purpose. Indeed there are very many ways by which arbitrating can be profitably conducted by bankers having the requisite facilities and the necessary skill for such operations. It will be observed that operations in arbitrating of exchange require the services of men of the largest experience; hence the business can be conducted to advantage only in most thoroly equipped offices.

3. *Parity*.—A parity is the price at which a bill should be quoted in order to compare it with the quotations for similar bills elsewhere. To make this comparison it is of course necessary to express every quotation in a common form. Care must also be taken

to bring quotations for long bills to a demand basis, by allowing for stamps and interest.

If the New York parity on Paris had been 5.1895,¹ on the old basis of francs per dollar as against the later rate of $5.167\frac{7}{8}$ in New York for Paris checks, an opportunity for arbitrage profit of 2.075 centimes per dollar would have been offered. On \$100 this would have amounted to 40 cents, and on \$48,754.56 to \$195. Bankers who engage in arbitrage transactions generally construct a parity table for ready reference between the more important exchanges. The following is an example of such a table, showing parities in dollars, francs and sovereigns. Similar tables may be made for sterling, marks and dollars, for francs, marks and dollars, etc.

£1 =	25.20	25.21	25.22	25.23	25.24	25.25
	\$1	\$1	\$1	\$1	\$1	\$1
\$4.85	5.1959	5.1979	5.20	5.2021	5.2041	5.2062
$4.85\frac{1}{4}$	5.1932	5.1953	5.1973	5.1994	5.2014	5.2035
$4.85\frac{1}{2}$	5.1905	5.1926	5.1947	5.1967	5.1988	5.2008
$4.85\frac{3}{4}$	5.1879	5.1900	5.1920	5.1910	5.1961	5.1982

¹ Attention is again called to the fact that a fixed exchange rate in one country is movable exchange in another, and both methods are used in arbitrage transactions in order to effect comparison. Paris quotes francs per dollar (i. e. fixed exchange to her but movable exchange to New York), and it is necessary to convert one or the other in order to compare.

The examples in this chapter are based upon normal conditions and the tables and calculations are given as they were used at that time. To convert the table on this page from movable to fixed exchange at New York is a matter of simple arithmetic and is most easily done by dividing the New York quotation for £ sterling by the London quotation for francs, as $\frac{4.85}{123.93}$, leading to the result 100 francs = \$3.913 + or nearest commercial rate \$3.92.

If the New York quotation for sterling was \$4.85 and the London quotation for francs 123.93, the New York parity quotation for francs would be 25.5463; if the market rate differed from this there would be an opportunity for arbitrage. Conversely, given the two franc quotations, the table shows the parity of the pound sterling in New York, or, given the sterling and franc rate in New York, the table shows the parity quotation of francs in London. Intermediate rates can be arrived at by interpolation. For instance, in the example given in Section 6, the sterling rate is 4.8560, the nearest quotation in the table is for 4.8550—a quarter cent making a difference of .0026 centime (25.5409—25.5383) in the quotation. Therefore, $\frac{10}{26} \times .0026 = .0010$ centime which, deducted from 25.5409, leaves 25.5399. The table is calculated by dividing the value of the sovereign in francs by its value in dollars, thus $\frac{123.93}{4.8560} = 25.5210.$

4. *Parity in stocks.*—Parity, when applied to a stock, means the price which is its equivalent when quoted in a different market. For instance, the London price of a stock exceeds the New York price of the same stock by about $2\frac{1}{2}$ or 3 per cent, after the exchange rate and the London method of quoting American stocks (\$5 to the pound) are taken into consideration. With a cable rate of $4.87\frac{1}{2}$ the London parity of New York stock at 68 would be 69.75.

$$\text{N. Y. parity} = \frac{\text{London quotation} \times \text{rate of exch.}}{5} \text{ or } \frac{69.74 \times 487\frac{1}{2}}{5} = 68.$$

$$\text{London parity} = \frac{\text{New York quotation} \times 5}{\text{Rate of exchange}} \text{ or } \frac{68 \times 5}{487\frac{1}{2}} = 69.74.$$

In commodities, the prices at two different centers are at parity when the difference represents only the actual cost of transportation, insurance and interest.

5. *Chain rule.*—Most of the calculations in arbitrage transactions can be put in the form of simple equations, and require only correct reasoning for their solution. A quick tho mechanical method of calculation is called the chain rule. It consists of arranging the terms of the exchange of the various currencies under consideration, in such a manner that the required equivalent, or parity, is easily obtained. A study of the following example will make the method clear:

Berlin check rate on New York is 95 cents per 4 marks,
 Berlin check rate on London is 20.5 marks per £1,
 Find the parity of the sovereign in New York.

How many $x = b$

if $b = c$

and $c = d$

and $d = 10 x$

\$ $x = £1$

£1 = 20.5 marks

Mks. 400 = \$95

$$X = \frac{1 \times 20.5 \times 95}{1 \times 400} = \$4.86875$$

The last term is always in the same currency as the unknown quantity, or first term. It will be noted that these quotations are arranged in such a manner that the denominations are in sequence like the links of a chain; hence the name. The value of the unknown

quantity (x) is then taken as equal to a fraction, the quantities on the right-hand side forming the numerator, and those on the left-hand side, the denominator. The product of the numerator divided by that of the denominator will give the required answer. "Chain rule" is applicable to all kinds of exchange and mercantile calculations.

How many dollars (x)	= £1
If the weight of £1	= 123.274 grains standard gold
If 12 grains of standard gold	= 11 grains of fine gold
And if 232.2 grains of fine gold	= \$10

$$x = \frac{1 \times 123.274 \times 11 \times 10}{1 \times 12 \times 232.2} = \$4.86656$$

6. *Simple arbitrage.*—The rate of exchange between two or more places corresponds or tends to correspond. In a preceding section it was shown how the exchange rate between two places is almost automatically adjusted. Similar influences in the form of arbitrage were brought into operation to synchronize the exchange rates the world over. There was thus a certain sympathy or relation between all foreign exchange quotations. The quotations in New York for exchange on Berlin or Paris were largely influenced by the price of sterling exchange. If the price of marks in New York should fall to a point where there would be a profit in an arbitrage transaction, the demand for drafts on Berlin, by those who wish to make this profit, would almost immediately force the mark

quotation up again. Similarly New York, while a debtor to England with consequent high sterling rates, may be the creditor of France or other countries in Europe, and drafts on these countries are remitted to London and thus tend to improve (i.e., lower) the rate of sterling exchange. When only three places are involved, the transaction is called simple arbitrage.

To give a concrete case of simple arbitrage: Suppose a banker in New York had the following data before him:

London check rate in New York..	\$4.8560 per £
Paris check rate in New York...	Fcs. 25.52 per \$
Paris check rate in London.....	Fcs. 123.93 per £

A brief calculation or a glance at his table of parities showed that there was an opportunity for a profitable arbitrage in francs between London and New York. He therefore sold a draft on Paris for Fcs. 252,000 at 25.52 and with the proceeds bought a draft for £2,000 at 4.8560 per £, at the same time cabling his London correspondent to purchase a draft for Fcs. 252,000 at 123.93 per £, or better, and send it to Paris to the credit of his account there. This purchase cost £2,000 and was provided for by a draft for the same amount remitted from New York. The banker's position was then as follows:

Sale of francs 252,000 at 25.52.....	\$9,874.60
Purchase of draft for £2,000 at 4.8560 to cover purchase of Fcs. 252,000 in London at 123.93	9,712.00
Profit	<u>\$162.60</u>

Without using any of his own capital and without any expense except the cost of a cable and a small commission to his London and Paris correspondents, the banker made a profit of over \$160. The result of this and similar transactions made at the same time by other New York bankers would be to lower the New York rate for francs by increasing the supply, and to raise the London rate by absorbing the supply, thus tending to equalize rates in those international exchange centers that might have been involved.

7. *Compound arbitrage.*—The foregoing example shows the simplest form of arbitrage, but it is typical of such transactions as they are normally carried out. The banker might have found it more profitable to provide cover for his draft on Paris by remitting marks to Berlin and purchasing his francs there, or he might have instructed his London correspondent to purchase and remit a draft to Berlin with instruction to the Berlin bankers to remit francs to Paris. In the first instance he simply substitutes Berlin for London in the transaction, but in the second instance he would operate both thru London and Berlin; four places are involved, and the transaction is known as compound arbitrage.

The study of arbitrage operations is both interesting and instructive. The following transaction will bring out some of the underlying principles more clearly:

PROBLEM: It is desired to transfer \$100,000 from New York to London on the basis of the data given in the first column. Which method of remittance should be selected?

It is first necessary to bring every quotation to a common form; for example, how many dollars equal £1. Care must be taken to bring quotations for long bills to a check basis, allowing for stamps, etc. The lowest parity in dollars will be the cheapest method of remitting to London, but the dearest return (remitting from London to New York), conversely the highest parity, is the dearest remittance and the cheapest return:

Factors:	Calculation.	\$ Price of £1 Check
A Berlin check in New York, Mk. 4 = 95 cents Berlin check in London, £ = Mk. 20.5	$\$X = \text{£1 check}$ $1 = 20.5 \text{ Mk.}$ $4 = .95$	
B New York check in Berlin, \$1 = Mk. 4.21 Berlin check in London, £1 = Mk. 20.50	$X = \$4.8387$ $\$X = \text{£1 check}$ $1 = \text{Mk. } 20.5$ $4.21 = \$1$	\$4.8687
C New York rate on Vienna, 20.30 cents per kronen..... Vienna check rate on Lon- don, 240.17½ kronen per £10	$X = \$4.8693$ $\$X = \text{£1}$ $\text{£10} = 240.17\frac{1}{2}$ $1 = 20.30 \text{ cents}$	\$4.8693
D London check in New York, \$4.8760	$\text{£10} = \$4.8755$	\$4.8755 \$4.8760
E Cable transfers to London in New York, \$4.8795..... London discount rate, 3%....	$\$4.8795 \text{ less } .0028$ (7 days' interest 3%)	\$4.8767
F London 60-days draft in New York, \$4.85.....	$\$4.85 \text{ plus } .0251$ (63 days' interest 3%) and stamps .0024	\$4.8775
G New York check in Paris, \$1 = Fcs. 25.40 Paris check in London, £1 = Fcs. 123.93	$\$X = \text{£1 check}$ $1 = 123.93 \text{ fcs.}$ $25.40 = \$1$ $X = \$4.8791$	\$4.8791

H Paris check^s in New York
 \$1 = Fcs. 25.01
 Paris Check in London,
 £1 = Fcs. 123.93

\$X = £1 check
 1 = 123.93 fc. chk.
 25.01 = \$1

X = \$4.9552

\$4.9552

A study of the above calculation shows that the cheapest method of remittance would be thru Berlin; a pound sterling costing \$4.8687. The transfer could be made either by forwarding to London a check on Berlin or by instructing the Berlin correspondent to draw on New York in favor of London. The sterling equivalent of \$100,000 on this basis would be £20,539:3:0.

The dearest method of remittance is via Paris, the difference between the Paris and the Berlin rates being 7.61 cents per £, or \$1535.70 on a transfer of \$100,000. The sterling equivalent of \$100,000 on this basis would be £20,180:8:2. It should be noted that as the Paris method of remittance is the dearest, it is the cheapest return and would therefore be selected for the transfer of money from London to New York.

8. *Arbitrage in gold.*—Arbitrage transactions in gold and silver are of a great variety but they are all founded on the idea of sending bullion to some point where it can be used to buy exchange cheaply on some other point. The one best known of these is the so-called "triangular operation," in which gold is shipped to Paris or some other European market for the purpose of buying exchange on London. The process is as follows: The gold is shipped to Paris, and exchange on London is there purchased with the proceeds.

This exchange is remitted to London for the credit of the American bank shipping the gold; the balance so created offsetting a demand draft drawn by the latter on London. The following are the details of an actual shipment made when francs were par 19.3¢:

48,500 ounces bar gold .955 fine at \$20.5684.....		\$997,567
Freight, $\frac{1}{8}$ per cent.....	\$1,247	
Insurance, $4\frac{1}{2}$ cents per \$100.....	450	
Interest 6 days at 2 per cent.....	333	
Assay office charge, 4 cents per \$100.....	400	
(From time gold is shipped to Paris until the drafts on London can be sold)		
Cartage and packing.....	60	
Com. in Paris.....	250	2,740
		<hr/>
		\$1,000,307
Bank of France buys gold .995 fine at fcs. 3419.81 per kilo (= 106.3705 francs per troy ounce)		
48,500 ounces at fcs. 106.3705 = fcs. 5,158,969		
Fcs. 5,158,969 at 25.10 = £205,536		
£205,536 at 4.8670 =		
		<hr/>
		\$1,000,342
		<hr/>
Profit.....	\$	35

REVIEW

What is arbitrage and what may it include?

What requirements are necessary in the work of an arbitrageur?

Define a parity. Give an example.

What is meant by parity in stocks?

Show, by examples, the difference between simple and compound arbitrage. What is the essential idea in gold arbitrage?

CHAPTER X

RATES OF INTEREST

1. *Interest an important factor in exchange quotations.*—The rate of interest at which the difference between long and short bills is calculated is based on the prevailing rate of the country on which the bill is drawn. This would not materially affect the situation if the rates of interest were uniform all over the world, but rates of interest in different financial centers vary considerably and these differences have an important bearing on exchange. Under normal conditions, international money and credit circulate most freely in the most attractive channels, and a rise in the interest rate in a foreign market will accelerate the flow of outside capital to that point, while a fall in the rate of interest will retard it. So, while demand and supply govern rates of exchange, the rates of interest at home and abroad react on these influences and affect demand and supply. Their combined effect causes the rates of exchange to fluctuate from day to day and thus the floating capital of the world is attracted from one center to another.

2. *Long bills.*—When we say that exchange rates between two countries usually fluctuate between the specie points, we refer only to the rate for demand or sight bills. This is sometimes called the pure rate of

exchange as it involves no time element except that required for the actual transmission of the draft.

Assuming that the rate at New York for a sight bill or check on London is 4.8725 how would the value of a sixty-days sight bill be ascertained? As payment in the latter case is deferred for sixty-three days (60 days + 3 days grace) it will be worth less than a demand bill by the interest for 63 days at the London rate. The calculation is based on the London rate of interest, because the holder of the bill in London can always discount it at the prevailing rate.

Assuming that the market discount rate for prime bills is 3 per cent, the rate for a sixty-days bill would be arrived at as follows:

Demand rate per £100.....	.....	\$487.25
Less 63-days interest.....	2.52	
Stamp 1/20.....	.24	2.76
		<hr/>
		\$484.49

corresponding to the nearest commercial rate, the figure would be \$4.8450.

If, therefore, we know the rate of interest prevailing in foreign markets and the stamp taxes imposed by foreign countries, the rate for any long bill can readily be computed from the demand rate.

3. *Bank rate*.—In London, the bank rate is the minimum rate at which the Bank of England will discount prime three months' bills or advance money against approved securities. This rate has a direct relation to the foreign exchange rate and the move-

ment of gold. An increase in the rate would raise the value of money and attract gold from foreign centers; the lowering of the rate would tend to lower the value of money and cause its withdrawal. The Bank of England sometimes insures the effectiveness of the rate by borrowing money in the open market, thus denuding it of supplies. The Bank of England has been governed in its action in raising or lowering the rate by the relation which its reserve of gold bore to its deposits. This proportion was seldom allowed to fall below 30 per cent, while it sometimes rose above 50 per cent, the average normal condition was about 43 per cent. The importance of keeping the gold reserve intact was appreciated and it was most important to the country, as the Bank of England is primarily a bankers' bank and in a great measure controlled the gold reserve of all the British banks.

In Paris, the bank rate is that fixed by the Bank of France, in Berlin that of the Reichsbank. In New York, the bank rate is the uniform rate of the banks as distinguished from the varying rates of the other lenders.

4. *Market rate.*—The market rate of discount, also known as the open market rate or private rate, in contradistinction to the official or bank rate, is the rate charged by bankers, bill brokers and others discounting bills of exchange. Because of competition it is usually a little lower than the bank rate, but as a rule follows the latter very closely.

Clean bills drawn upon bankers are discounted at

the private rate, while those drawn upon firms in good standing are generally discounted at about $\frac{1}{4}$ per cent above the private rate.

The Bank of England rate governs the rate of interest paid on deposits by the London joint stock banks. This rate is generally $1\frac{1}{2}$ per cent below the Bank of England rate.

5. *Retirement rate.*—In cases where bills have documents attached, with instructions to accept payment “under a rebate of $\frac{1}{2}$ per cent above the rate of interest allowed on deposits by joint stock banks,” if the bank rate were 4 per cent the deposit rate would be $2\frac{1}{2}$ per cent and the rebate rate three per cent. This is known as the “retirement” rate, and the bill is said to be taken up “under rebate” in order that the drawer may obtain possession of the relative goods before maturity. Such bills are known as D/P bills (documents on payment) and are not discounted by English banks.

6. *Importance of the Bank of England rate.*—The movement of gold from one country to another, or even the probability of such a movement, is an important factor in determining the rates of exchange on the countries affected. London, owing to the extreme sensitiveness of the Bank of England rate to gold movements in normal times is particularly interested in its discount rate. Suppose, for instance, that in normal times, on account of a low sterling rate, New York commences to import gold from London. The Bank of England, seeing its stock of gold be-

coming too low, raises its official rate of discount, which is the term applied to the minimum rate at which it will discount approved bills. The London market, whose rate is usually a little lower than that of the Bank of England, will probably rise in sympathy, but if it does not do so the Bank of England, by borrowing money in the open market, will force up the rate and the effect of dear money is soon apparent. The foreign money markets, in order to take advantage of the higher interest rate in London, will allow their balances to accumulate there for investment or will purchase bills on London. British merchants will decrease their imports and increase their exports. In this way the balance of payments gradually swings around again in favor of Great Britain. Exports of gold, therefore, cause sterling rates in New York and elsewhere to stiffen and, if the high rate is maintained sufficiently long, it will check the export and eventually induce an inflow of gold to London. Thus, the reserves of the Bank of England will again become normal and the rate will then be reduced. The importance of the Bank of England rate in controlling international exchange and gold movements cannot be overestimated, and its effects are so far reaching that monetary conditions thruout the world are directly or indirectly influenced by it. The rate is fixed by the directors of the bank on Thursday of each week and tho as few changes as possible are made, the publication of the rate is always a matter of interest to the financial world.

The Bank of England is, at all times, fully prepared to make advances against satisfactory collateral, or to rediscount approved acceptances at its minimum rate of discount. Facilities of this nature naturally create a feeling of stability and confidence among the English bankers, and the protection and assistance at their command in times of emergency enable them to conduct their business on a smaller cash reserve basis than is possible by bankers in countries without similar protection.

7. *What the Bank of England rate effects.*—It has been said that the Bank of England rate acts in normal times as a barometer of the financial condition of the world and any features of political or economic significance are reflected by its course.

Mr. A. W. Margraff¹ in pointing out the importance attaching to the fluctuation of the discount rate of the Bank of England states the various results which are effected as follows:

The discount rate:

1. Establishes the minimum rate at which the Bank of England will discount acceptable paper.

2. Fixes the rate of interest allowed by London joint-stock companies on short deposits, since this rate is one and one-half per cent under the Bank of England rate.

3. Determines the rate of interest allowed by London bankers on cash balances to the credit of foreign correspondents, keeping active accounts with them, in so much that this rate is usually $\frac{1}{2}$ to 1% below the Bank rate.

4. Serves also to fix the rate of interest charged on cash

¹ "International Exchange" by A. W. Margraff.

overdrafts, on running accounts, as debit balances are generally subject to the Bank rate, or $\frac{1}{2}\%$ to 1% above, according to agreement.

5. Establishes the open market discount rate in Great Britain at which private bankers, London joint stock companies and discount houses will discount paper for local or foreign account, the rate ordinarily being from $\frac{1}{4}\%$ to $\frac{1}{2}\%$ below the Bank rate.

6. Governs the "Retirement Rate of Discount" on documentary payment bills, which is the rate of interest rebated to the drawee, or acceptor of a documentary payment bill for the time from the date of retirement or prepayment to the date of maturity of the bill, this rate being $\frac{1}{2}\%$ above the rate of interest allowed by London joint-stock companies for short-time deposits, which rate is based on the Bank rate as above.

7. Affects the value of all international bills of exchange as an advance in the Bank rate either advances the rate of exchange for a demand sterling draft in a foreign country or depreciates the worth of a long time sterling bill, as the interest rate for credit balances and the discount rate for long time paper are indirectly dependent upon the Bank rate.

8. Has the power of protecting the gold reserve held by the Bank of England and of checking any protracted movements of gold importations by foreign nations, in so much as an advance in the Bank rate adjusts the rates of foreign exchange to a point where operations of this nature become unprofitable.

9. Invites and attracts the deposits of foreign banks with London correspondents as an advance in the Bank rate to a figure in excess of the earning capacity at home induces continental money lenders to seek the London market for investment of their funds.

10. Indirectly has a tendency to depress or advance the values of stocks listed on the New York Stock Exchange—an advance in the Bank rate causing a decline in stock values, and a reduction in the Bank rate usually having

the opposite effect, because the values of stocks are largely dependent upon the monetary conditions obtaining in New York, and as New York bankers in periods of stringency nowadays resort to relieve the situation by issuing Finance Bills drawn upon English bankers, the Bank of England rate indirectly either facilitates or precludes their course of action.

The influence of the Bank of England's discount rate upon securities listed on the New York Stock Exchange is less pronounced than formerly, due to increase in the relative importance of New York as a world financial center.

REVIEW

What effect has the interest rate on exchange quotations?

What is the bank rate in London and what relation has it to the foreign exchange rate and the movement of gold? What is the bank rate in: France, Berlin, New York?

Discuss the market rate of discount; the retirement rate.

Show how the Bank of England rate is an important factor in determining rates of exchange.

CHAPTER XI

BILLS OF EXCHANGE

1. *Bills of exchange*.—It has already been indicated that the fundamental purpose of a draft or bill of exchange is to settle debts and thus avoid the necessity of shipping gold. To satisfy a debt in one country by offsetting the amount against a debt due in another country, leaving only the difference, if any, to be remitted in gold, is no less effective a means of payment than a double shipment of money, and is obviously more economical. In this way, the difference or balance of payments as it is called, is settled by the debtor nation shipping gold or arranging a postponement of payment by means of finance bills or other corrective transactions.

A check is merely a demand bill of exchange drawn on a bank. Bills of exchange or drafts, as we shall now call them, assume a variety of forms and tenor, but, no matter what their currency or form, the underlying principle is the same, namely, that of a creditor drawing a draft upon an actual or constructive debtor.

Bills of exchange can be broadly divided into two classes according to their currency, known as short and long exchange.

Short exchange includes cable transfers, checks, bank drafts and sight or demand drafts. 'Travelers' checks, money orders and other forms of non-commercial remittances come under this heading.

Long exchange includes all drafts with a currency of eight days or over, such as thirty and sixty-day commercial bills and bankers' long bills.

2. *Sight drafts*.—Checks and demand or sight drafts, whether drawn on a bank or a commercial house, have no days of grace for payment and must be paid on presentation, or protested. As a rule the sale of demand exchange is confined principally to banks, commercial drafts being usually drawn on time.

The rate or price of demand or sight exchange, under modern conditions, may be considered as the basic rate on which all rates for time exchange are calculated. The old usance or sixty-day rate, obtaining between London and New York, on which rates used to be calculated is a relic of the days of slow-going sailing vessels. In practice, of course, given the rate of interest, the rates of exchange are quickly converted from one to the other. Under normal conditions, a sight draft drawn in New York or London will be presented and paid six to eight days after negotiation in New York, and is therefore, as regards time lost in transit, on a par with a shipment of gold. The difference between the export gold point and the demand rate is represented by the freight, insurance charges, etc., on the shipment of gold. It is, of course, necessary for banks transacting a regular foreign ex-

GUARANTY TRUST COMPANY
OF NEW YORK

EXCHANGE FOR	
£.....	Stg. New York, .....19.....
On demand please pay.....	
or order (Original being unpaid) the sum of.....	Sterling
which charge to New York account	
To	
Guaranty Trust Company of New York,	
33 Lombard Street,	
No.....	MANAGER

FIGURE 6. DEMAND DRAFT

change business to maintain balances with the various foreign correspondents against which they can draw demand drafts and sell cable transfers. Funds for these balances are provided by remitting quantities of different kinds of exchange which have been purchased from customers and others. Demand and other short date items are credited immediately; acceptance is obtained of the longer date items which are discounted and credited by the correspondent as occasion requires.

The selling of demand exchange and cables against remittances of the same is the most elementary form of foreign exchange. A banker, for instance, purchases a demand draft on London for £10,000 at the normal rate of exchange, say \$4.86, and remits the bill to his London correspondent; at the same time he sells his own check or checks on London for the same amount at, say, \$4.86½; the two transactions reach London by the same mail and offset each other. Apart from the expense of conducting his business, he clears \$50 on the transaction and is not out of the use of his money for more than a few hours at the most. If the checks sold by the banker miss the mails by any chance, the banker has the use of the money in London until the mail is received; hence the importance of watching the mail service closely in exchange transactions. This illustration is, of course, elementary and bankers do not often make money this way; but it shows the principle on which foreign exchange transactions are based. Banks are constantly purchasing every kind of exchange and for-

Sherbrooke, Que. 10th November 19-

£956-8-7
Sixty days after

sight of this FIRST of Exchange (Second unpaid) pay to the order of.....
The Canadian Bank of Commerce.....the sum of
Nine hundred and fifty-six pounds 8 $\frac{7}{8}$ Sterling,
Value received, and charge the same to account of
To

Davis, Jones & Co.
18 Harbour St.
Liverpool.
No. B. E. 28

Barclay & Dawson.

FIGURE 7. SIXTY-DAY BILL (FIRST)

THE CANADIAN BANK

Sherbrooke, Que. 10th November 19-

£956-8-7
Sixty days after

sight of this SECOND of Exchange (First unpaid) pay to the order of.....
The Canadian Bank of Commerce.....the sum of
Nine hundred and fifty-six pounds 8 $\frac{7}{8}$ Sterling,
Value received, and charge the same to account of
To

Davis, Jones & Co.
18 Harbour St.
Liverpool.
No. B. E. 28

Barclay & Dawson.

FIGURE 7a SIXTY-DAY BILL (SECOND)

warding it to their foreign correspondents by whom it is converted into an available balance. In any case there is constantly accumulating to the credit of the New York banker a balance against which he is able to sell exchange and cables and meet his maturing obligations. Under normal conditions, owing to the reliability of the mail service, a banker is able to estimate very closely the position of his London balance and as a rule receives a cable from his correspondent at the end of each day.

3. *Cable transfers*.—A cable transfer or “cable,” as it is more generally called, is a transfer of funds by cable, no question of interest being involved as payment is immediate. Apart from this a “cable” differs from a check only in the fact that the banker abroad is told by a cable, instead of by a written order or check sent by mail, to pay out the money. The cable dispatches should be sent the night before, or early on the morning of the day on which payment is due; otherwise, owing to the difference of time between New York and London, the London bank will be closed and the payment delayed until the following day. As the money is received and paid on the same day, it is obvious that the banker must charge a higher rate of exchange for a cable than he would for a check, because he has the use of the amount of the latter while it is in transit. The mail time between the two points involved and the current interest rate at the paying point are the main factors which determine the difference in the rate of exchange between cables and

demand drafts. The higher the rate of interest and the slower the mail steamer, the more the quotations diverge. With a demand rate of exchange at \$4.86, an eight-day steamer and a London market rate at $4\frac{7}{8}$ per cent, the cable equivalent would be 4.8652 , $4.86 + .0052$ (8 days' interest). These rates are rendered more or less divergent according to the supply of or demand for checks and cables respectively.

4. *Unusual rates for cables.*—It has already been noted that the outbreak of the European war raised cable rates on London to an unprecedented point. In his work on "International Exchange" Mr. A. W. Margraff summarizes the ordinary business conditions which produce abnormal rates as follows:

1. Flurries on the New York Stock Exchange with the incidental abnormal high rates for money, frequently induce New York bankers to sell their checks on London for amounts largely in excess of their cash credit balances in the hands of their London bankers, and enable them to relieve the stringency of the money market and at the same time obtain a higher rate of interest by loaning the money realized in selling their London checks.

The manner of covering those checks prior to their presentation for payment in London is and can be effected only thru the purchase of cable transfers, and these operations when indulged in extensively, naturally create a brisk market demand for cable transfers, and fancy prices in many instances have to be paid.

2. Exceptionally high rates for London checks, caused by an unexpectedly heavy inquiry and a scant supply of commercial bills of exchange, might tempt the aggressive banker to avail himself of the high price by selling his checks on London short, basing his calculations on a decline in the price of exchange, during the transit of his

checks to a point where he can buy cable transfers in reimbursement for approximately the same rate he sold his checks, and in that event he would have had the free use of the proceeds of his sale of checks in the interim for loaning purposes.

Unforeseen circumstances often offset the calculations of the financier, and instead of the anticipated decline, the market has remained stationary or in fact had an advance and in the face of these conditions the many short sales of checks must still be covered by cable transfers at about any price the seller may dictate.

3. The fortnightly settlement days on the London Stock Exchange occurring about the middle and the end of each month influence also the price for cable transfers, and New York banking firms engaged in transactions in the London market frequently are called upon, especially in a wide and fluctuating market, to protect their operations by the cash payment on these days, of very large sums of money that are transferred by telegraph and result in a heavy demand for cable transfers.

4. There are many bankers not averse to having their foreign accounts show a debit balance at various times thruout the half-yearly account periods, and who thru a sentiment of pride and an implied request on the part of their European friends, always close their accounts on 30th June and 31st December with a liberal cash credit balance created in most cases at the last moment by the purchase of cable transfers.

The demand for cable transfers thru this source is sufficiently large to induce some bankers to establish large credit balances with their London friends during the months of June and December, thereby placing themselves in a position to sell cable transfers on 29th June and 30th December at the advanced prices which usually obtained then.

5. *Long exchange*.—Long-time drafts may be divided into bankers' long bills and commercial long

bills; both classes are drawn at sixty or ninety days after sight, except in special cases, when the time limit may be longer.

Commercial long bills with or without documents attached are drawn on foreign debtors by merchants and exporters against shipments of goods abroad; they are usually purchased by bankers who remit them to their foreign correspondents for collection and credit and sell their own bills against the balance so created.

When a bill of exchange is drawn for the exact value of the goods exported and has the bill of lading insurance certificates, etc., attached, it is known as a "documentary" bill of exchange. If no documents are attached to a bill, it is known as a "clean" bill of exchange. Bankers' bills are invariably clean bills, while commercial bills, unless drawn by a house of high standing on another of equal rating, are usually documentary.

Bills of exchange and the accompanying documents are usually drawn in duplicate. The originals are forwarded on the first outgoing steamer, the duplicates are sent by the next mail. Sometimes the second bill of exchange is retained until a satisfactory sale can be made, in which case the maturity of the bill is based on the date that the first of exchange was accepted in London, accurately determined by the arrival of the mail boat. The second bill of exchange bears the name and address of the holder of the accepted bill. Before payment the duplicate is at-

tached to the original. A bill of exchange may be taken up any number of times before it is due and be put into circulation between each payment, but once it is paid by the acceptor on its becoming due it cannot again be put into circulation.

6. *Influence of the interest rate.*—A bill drawn, say, on London at sixty days after sight is obviously not worth as much to the purchaser as a demand bill. He has to pay for a sixty-day bill on delivery, send it over to London, obtain acceptance, and wait sixty-three days after acceptance before the bill matures and is paid; in other words, there is sixty-three days difference between the currencies of a demand and a sixty-day bill. Should the purchaser find it inconvenient to await the maturity of the bill, he can instruct his correspondent in London to discount it at the current rate, and have the proceeds placed to his credit. In all exchange calculations, therefore, the rate of interest is based on the current rates obtaining in the country on which the bill is drawn; this rate varies slightly according to the nature of the bill. The rates normally applicable to various classes of bills are, roughly, as follows:

Clean bills drawn on bankers—private discount rate.

Clean bills drawn on first-class firms— $\frac{1}{4}\%$ above private discount rate.

Bills, with documents deliverable on acceptance— $\frac{3}{4}\%$ below Bank of England minimum discount rate.

Bills drawn at over sixty days sight, bear a higher

rate of discount, as a rule, than the market rate for sixties, owing to the element of risk on account of the possible change in the discount rate during the currency of the bill. It is obvious that if the London rate of discount happens to be higher than the New York rate, the purchaser of a sixty-day bill would probably prefer to allow the bill to run to maturity rather than discount it in London and use the proceeds in New York. Conversely, if the London rate were the lower he would prefer to discount the bill and withdraw the proceeds for use in New York. From the foregoing it will be seen that the London rate has a powerful influence on the exchange market. The higher the rate of discount the greater the divergence between the rate of exchange on long and short bills on London. A change in the interest rates of either London or New York is immediately reflected in the price of any bill. The conversion of a demand rate to a sixty-day rate includes an allowance for interest and British revenue stamps (1 shilling per £100). With a demand rate of 4.87 and a private discount rate in London of $3\frac{1}{2}\%$ per cent, a banker's clean bill is worth 4.8385 as the following calculation shows:

New York demand rate on London	\$487.	per £100
less 63 days' interest at $3\frac{1}{2}\%$	2.93	
Stamp duty $\frac{1}{20}\%$ . . . . .	.24	3.17
	<hr/>	
	\$483.83	

or the nearest commercial rate, \$4.8385 per pound

sterling. Elsewhere it has been shown that exchange rates between two countries either correspond or tend to correspond; this applies, however, only to the demand rates.

7. *Commercial long bills.*—Commercial long bills are drafts drawn at thirty days or over by exporters on foreign customers, or upon banks abroad designated by the latter. A bill of this kind is usually accompanied by a bill of lading and other documents. Where a draft is drawn on a very good house abroad, or a bank, the documents are delivered upon the acceptance of the draft. Such drafts are known as “acceptance bills” or D/A.

Where the drawee’s standing is less well-known or where the merchandise is perishable, documents are delivered only on actual payment of the drafts. These drafts are known as “payment bills” or D/P. In the case of a draft marked D/A, the drawee can obtain possession of the relative goods as soon as he, or the bank representing him, has accepted the draft. If the draft be marked D/P, the drawee must pay the draft (less a rebate for any unexpired time it has to run to maturity) before he can obtain the merchandise. When D/P bills are drawn against perishable goods they are invariably taken up “under rebate.” Payment bills are not discountable, even after acceptance, as they are liable to be paid any time before maturity and must, therefore, remain in the portfolio of the banker who presented them for acceptance. “Acceptance bills,” on the

other hand, become clean bills after acceptance. They are discountable in the London discount market and may change hands a half a dozen times before maturity.

The purchase of documentary bills drawn by reliable firms is a fairly safe operation, the buyer being protected by the bill of lading which is indorsed to him, but judgment should be exercised as regards the financial standing of the drawer and drawee, especially in the case of "acceptance bills," and consideration should be given to the nature of the relative goods.

8. *Bankers' long bills.*—Drafts drawn at sixty and ninety days sight, on foreign correspondents by bankers in the United States and Canada, form an important factor in international exchange operations. These bills originate in the regular course of a foreign exchange business and are based on a variety of transactions. Many of them are thirty and sixty-day bills and are sold to customers of the bank, who prefer this method of remittance to that of purchasing demand drafts or cable transfers. Some arise from a desire to anticipate a change in the rate of exchange, while others represent purely financial transactions, such as placing a foreign loan in New York. These latter operations are explained in the chapter on Finance Bills.

9. *Bills of exchange that involve more or less risk.*—Concerning the risk incurred in the purchase of documentary exchange, A. W. Margraff in his book "International Exchange" writes as follows:

Bills of exchange that may be purchased safely.—Bills accompanied by documents covering staple, non-perishable merchandise can be readily resold in the market where consigned in the event of forced sale by reason of non-acceptance or non-payment by the drawees of the appertaining bill, and the inability of drawers to reimburse the purchaser of the bill upon demand for the amount originally paid them, plus expenses.

The proceeds realized upon merchandise disposed of under forced sale would be applied on account of the amount of reimbursement demanded of drawers, and provided the merchandise was of the nature just referred to, would almost liquidate the purchaser's claim against the drawers, and the small balance still due to the purchaser may be recovered with little difficulty from the drawers. If, however, they have failed in the meantime, then the purchaser would have a creditor's claim for such balance against the insolvent drawers.

The possibility of such a loss is very remote in view of the fact that the majority of drawers of bills of exchange (exporters) have all refused bills immediately referred to their own agents abroad for protection.

Staple and non-perishable merchandise includes flour and other manufactured cereals such as corn meal, oat meal, hominy, etc.; farming implements, canned meats, fresh meats and other provisions, when the fresh meats and provisions are shipped in refrigerator cars and vessels of modern type, and warehoused in cold-storage plants upon the arrival at destination, if not immediately taken up by drawees.

Bills involving more or less risk.—Bills accompanied by documents representing shipments of perishable merchandise, such as butter, cheese, fresh fruits, etc., that are liable to deterioration in quality, or to absolute loss, during transit.

Bills with documents showing collateral security of live cattle, horses or other live animals, necessitating the expense of help and feed during transit for the maintenance

of life, as a refusal of such annexed bill would depreciate the value of the security, day by day, to the extent of such expense incurred.

In addition to the liability of drawers and indorsers, if any, purchasers of documentary bills are secured by the financial responsibility of the acceptors on and after acceptance until actual payment of the bills.

The liability of drawers continues after the acceptance of bills, remains in force during the whole life of the bills and ceases only upon payment.

The primary conditions of the desirability of the purchase of any bill of exchange depend upon the moral and financial standing of the parties thereto, and the liabilities just stated of the parties should be quite ample in the majority of cases. Further, these bills possess another element of protection against a possible loss in this, that they are supplemented by documents covering salable merchandise with title continuing in the purchaser of the bills until payment at maturity, or retirement prior to maturity, of the respective bills of exchange.

REVIEW

What are the two classes of bills of exchange and what does each include?

How does a cable transfer differ from a check? Why are higher rates of exchange charged for it than for a check? What are the main factors which determine the difference in exchange rates between cable transfers and demand drafts?

What conditions will tend to produce abnormal cable rates? Discuss.

What are: (a) commercial long bills; (b) documentary bills of exchange; (c) clean bills of exchange? Give an illustration of a clean bill and of a documentary bill.

Describe the kind of bills of exchange which are considered safe to buy and those which involve risk. What are the primary conditions which make the purchase of a bill of exchange desirable?

CHAPTER XII

FOREIGN REMITTANCES

1. *Non-commercial exchange*.—Altho the greater portion of foreign exchange originates in commercial transactions, there is a constantly increasing volume of exchange business created by travelers and immigration. A steady stream of travelers and others leave the United States and Canada each year to visit Great Britain, Europe and other parts of the world, carrying with them the necessary funds for their expenses in various forms, such as circular letters of credit, travelers' checks, drafts and gold.

The remittances of immigrants to their relatives and friends in their home lands amount to a surprisingly large figure, probably \$275,000,000 or more, in the course of a year. These remittances are generally made by means of drafts, foreign money orders, or by what are called mail remittances.

For many years these two classes of foreign business were in the hands of foreign bankers who made a specialty of the business of supplying banks, both in the United States and Canada, with the necessary forms and foreign machinery for issuing circular letters of credit and selling travelers' checks. Gradually the larger banks both in the United States and

Canada felt the increasing pressure of their clients' requirements in this connection, and found it advisable to establish their own systems of travelers' checks, etc. Practically every important bank has now direct correspondents in the principal cities of the world with whom they have made the necessary arrangements for the payment of circular letters, travelers' checks and the like.

A comparison of the different methods of remittance and a description of the manner in which they are operated is interesting.

2. *Principles underlying the issuance of drafts.*—

A demand draft or check is an unconditional order issued by one bank on another bank or banking firm asking the bank to whom it is addressed to pay a certain sum of money to a specified person or institution. (See Figure 8.)

In the case of a bank keeping an account in another country where the exchange value of the currency is steady and for which rate quotations are easily obtainable, drafts are usually drawn in the currency of that country and, after payment, are charged to the account which the issuing bank keeps with its correspondent at the face amount. If the arrangement calls for payment of the drafts at par, the correspondent's commission (if any) is added to the face amount of the draft when charged to the account. Drafts are often made payable at the office of a third bank or banking firm for account of the issuing bank's correspondent.

Drafts are also issued on correspondents with whom no account is kept. In such cases, cover-drafts in favor of the correspondent for the amounts involved

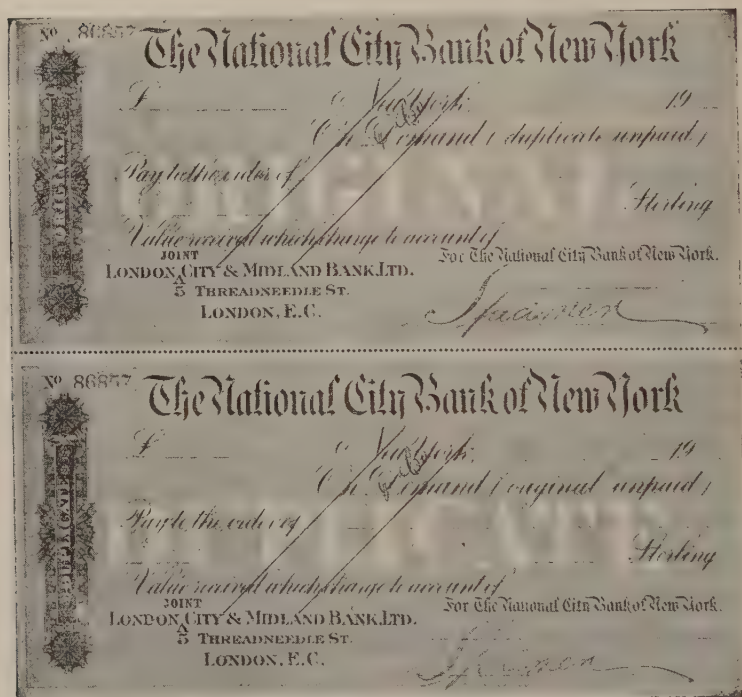


FIGURE 8. DRAFT

plus commission, drawn against the issuing bank's account in one of the large selling cities (London, Paris, Berlin, New York, etc.) are forwarded with the relative letters of advice, or the correspondent is requested to forward the paid draft to the issuing

bank's correspondent in one of these cities for redemption.

When a bank is requested to issue drafts on a country for which it has made no draft arrangements, a sterling draft on its London branch or correspondent was usually sold. Sterling drafts on London have been more easily negotiated than those drawn in other currencies, owing to the fact that the great majority of banks thruout the world have correspondents or accounts in that city, and the exchange rates for sterling were much steadier and more widely quoted than those for other currencies.

To guard against loss in the case of countries in Africa, Asia or South America where silver units exist or the exchange value of the currency is subject to great fluctuations, drafts are usually drawn in sterling on the London branch or correspondent of the issuing bank and crossed "Payable at the drawees' buying rate for sight bills on London," or with a phrase similar in meaning. The correspondent on whom such drafts are drawn pays them in local currency at a rate of exchange which includes his commission and other charges, and afterward forwards them to London for redemption at the face amount of sterling.

3. *Advices*.—A letter of advice (Figure 9), authenticating the draft and usually containing the following particulars, is sent to the branch or correspondent on whom the draft is drawn:

(a) Number of the draft

- (b) Amount of the draft
- (c) Date of issue of draft
- (d) Name of payee
- (e) Name of bank at which drafts will be presented by bearer if other than correspondent drawn on

[illegible]

FIGURE 9. LETTER OF ADVICE (DRAFTS)

on (if the draft is to be readvised to bank at which it will be presented, a note to this effect is added to the advice).

(f) Particulars of the mode of reimbursement (cover-draft inclosed, debit amount to account, etc.).

Should the draft be payable by a third party (see above) for account of the correspondent on whom it is drawn, this third party is also advised either by the issuing bank direct or by its correspondent on receipt of advice from the issuing bank.

The relative advices should be dispatched as soon as possible after the sale of the drafts in order that payment may not be refused thru the correspondent's being unable (in the absence of advice) to authenticate the drafts.

4. *Specimen forms and signatures.*—Each bank furnishes the correspondents on whom it has arranged to issue drafts, with specimens of the special draft form and of the special advice form (if any) it will use, together with specimen signatures of the officers who are authorized to sign drafts and advices on its behalf. If possible, a specimen signature of the payee is also forwarded with the advice of a draft, so that any possible difficulty in establishing the *bona fides* of the payee and draft may be avoided.

5. *Cost of drafts to purchasers.*—The amount to be charged by the issuing bank to the purchaser of a demand draft is ascertained by adding together the amounts mentioned below:

(a) Face amount of the draft (if drawn in a for-

eign currency the amount is converted into local currency at the rate of exchange for the day)

- (b) Commission of the issuing bank
- (c) Commission (if any) of the paying bank
- (d) Cost of postage on advices.

(7) *Travelers' checks*.—Travelers' checks enable a traveler to provide himself with funds without delay in a convenient yet inexpensive manner, at any point of his journey. They are issued in denominations of even amounts (\$10, \$20, \$50, \$100 and \$200; £5, £10; 200 francs and 400 francs. Equivalents in foreign money are now no longer stated upon such checks. (See Figures 10 and 11.) They may be cashed practically anywhere, are self-identifying and easily negotiated, and are therefore one of the safest and best forms in which to carry money when traveling. They are issued by all first-class banks at a small premium.

So far as travelers are concerned, such checks are often more convenient than drafts. The latter must be cashed in one lump sum which may be much larger than the traveler wishes to carry on his person, and which may be a positive disadvantage if he passes into another country where a different currency is in use. The checks are for relatively small amounts, can be cashed as needed and are generally accepted by hotels and large stores, without imposing on the traveler the burden of cashing them at a bank.

In view of the undoubted advantages in their particular sphere which travelers' checks possess over

drafts, their greater cost, the widespread nature of the initial arrangements and the fact that the exchange charged by correspondents on the checks is met by the issuing bank, the slightly higher commission charge which is made by banks for travelers' checks is fully justified.

7. *Payment of checks.*—The issuing bank usually holds the paying agents of their travelers' checks free from responsibility in cashing such checks, provided:

(a) The holder signs them in the presence of the paying agent.

(b) The signature of the holder and that of the countersigning officer agree with the signatures contained in the relative letter of indication.

(c) The numbers of the checks are entered on the letter of indication.

(d) The checks are negotiated within the period specified (usually twelve months from date of issue).

(e) The other general terms of the circular of instructions are duly complied with.¹

8. *Payment to holders.*—In countries other than France or Great Britain travelers' checks are now paid in local currency at the day's rate for the country in whose currency they are drawn. When revenue stamps are required their price is deducted.

When a fixed amount of sterling is specified for Great Britain on the face of travelers' checks, it should

¹ This circular of instructions is generally printed in the principal commercial languages for the benefit of paying agents.

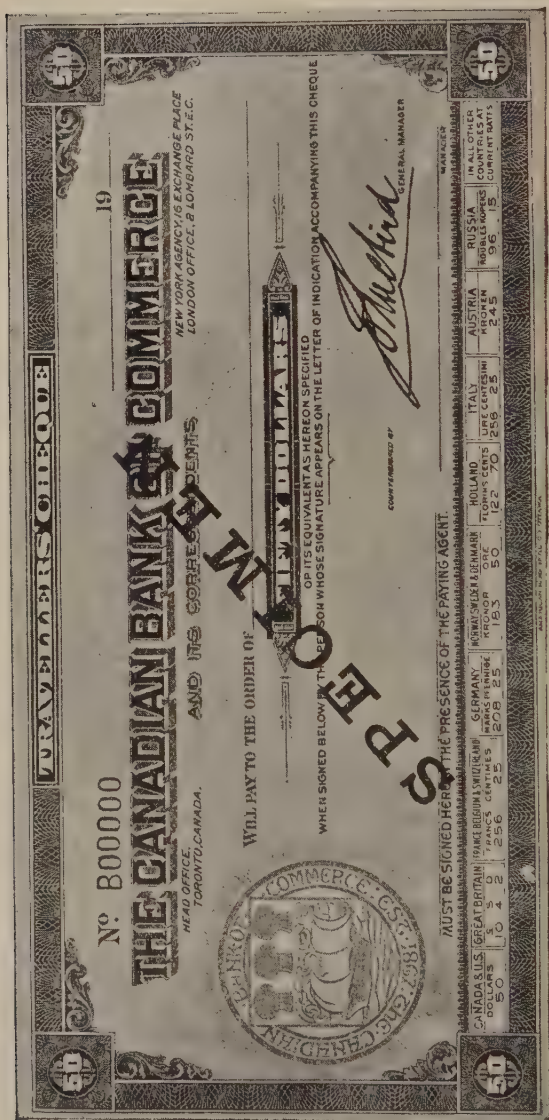


FIGURE 10. TRAVELERS' CHECK

During the war the equivalents designated as payable in enemy countries, or countries occupied by the enemy, were canceled.

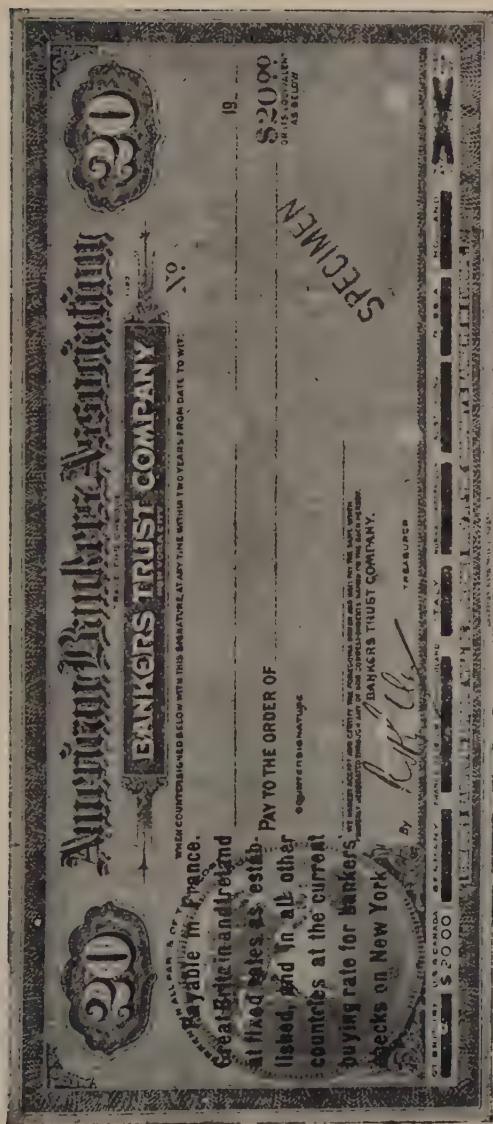


FIGURE 11. TRAVELERS' CHECK

“Owing to the unsettled political conditions and the consequent irregularity of exchange rates, it is not feasible to show rates on checks which may be printed some time before actual sale to travelers. Fixed rates are established from time to time with French and English correspondents and these rates may be obtained by the traveler at the time of purchase by inquiry at the issuing bank, who are advised of such changes.”

be borne in mind that the sterling current in Australia, British South Africa, British West Indies, etc., is of a quite different exchange value. A similar remark may also be made regarding the colonies and dependencies of other countries which use the same currency (francs, etc.) as the respective mother country. In such places all travelers' checks are paid at the current rate for purchasing exchange on the capital of the respective mother country.

9. *Redemption of checks.*—Paid travelers' checks are redeemed as follows:

(a) If paid in North America, they are forwarded to the New York office or correspondent of the issuing bank of redemption at the face amount of dollars plus the commission agreed upon.¹

(b) If paid outside North America, they are forwarded to the London, England, branch or correspondent of the issuing bank for redemption at the current rate of exchange plus commission at the rate agreed upon or when issued in dollars are returned to New York either directly or indirectly to be redeemed to the credit of the foreign banker who cashed them. A number of purely temporary expedients have been resorted to in view of the unsettled condition of ster-

¹ As travelers' checks paid in North America are checks on New York, banks at points where New York exchange is usually at a premium often make no commission charge for cashing the checks.

In the case of Canadian banks which issue travelers' checks, it is customary to redeem each other's checks at par when the two banks concerned are represented locally. In other cases they are redeemed thru the Clearing House or otherwise by any branch of the issuing bank which is convenient for the purpose, at the face amount plus the usual commission on checks paid and redeemed in North America, namely, $\frac{1}{10}$ of 1 per cent, minimum 5 cents each.

ling. It is believed these will in time give place to the former more convenient methods.

(c) Banks having extensive business relations with various European countries occasionally appoint their chief correspondents in the respective countries as central redemption agents for their travelers' checks. In such cases the paid checks are forwarded to these correspondents for redemption at the face amount of local currency plus the commission agreed upon, and are debited to the account which the issuing banks keep with these correspondents.

(d) Hotels, department stores and private bankers often hand travelers' checks paid by them to a local bank for redemption, such third parties being allowed a commission of, say, $\frac{1}{20}$ of 1 per cent, which is added by the local bank to its own commission when forwarding the check to a central correspondent for redemption.

10. *Letter of indication.*—Each purchaser of travelers' checks is furnished with a letter of indication (Figure 12), usually bound with the list of paying agents, specifying the numbers of the travelers' checks sold to him and signed by the purchaser and the officer who countersigned the checks. It is indispensable to the security of the holder that this letter of indication be carried separately from the travelers' checks, as in case of loss of one or the other the one remaining serves as the basis of a claim for reimbursement.

A few institutions do not issue a letter of indication with their travelers' checks. In these cases two

spaces, one at the top and one at the bottom (see Figure 13), are provided on the check form for the signature of the holder. The first signature is made in the presence of the officer who issues the checks, and the second in the presence of the paying agent, who compares the two signatures to establish their identity. This system, however, readily lends itself to forgery should the checks be lost or stolen, as the presenter of the checks has a copy of the necessary signature before him while signing the checks, or the signature may be lightly traced in pencil in the space provided before presentation and covered with ink in the presence of the paying agent.

During 1913 the *Fédération Universelle des Sociétés d'Hôteliers* (with which the principal hotels of the world are associated) addressed a circular letter to the various issuers of travelers' checks stating that in view of the risk involved, payment by the leading hotels of travelers' checks of this form would thereafter be more or less uncertain, and suggesting that the banks adopt the safer method whereby the specimen signatures of the purchaser and the countersigning officer are given in a separate letter of indication.

11. *Lost travelers' checks.*—The same care should be taken of travelers' checks as of money, and due precautions taken to avoid risk of loss. Should this occur, however, the holder is advised to communicate immediately by telegraph with one of the redemption agencies of the issuing bank or the branch at which

the checks were obtained, so that the presenter of such checks may be traced without delay.

The issuing bank will usually refund to the owner the face value of lost or destroyed checks, or will issue a new supply in their stead, upon receipt of sufficient evidence of loss or destruction thereof and the execution of a satisfactory bond of indemnity, provided the holder immediately notifies the bank by telegraph of the loss as mentioned above.

Travelers' checks are useful for those carrying comparatively small sums of money, as they can be negotiated at hotels, department stores, etc., where it is impossible to secure funds under letters of credit, but those who require to provide themselves with large sums, say, \$1,000 or over, will find a letter of credit more convenient. A good plan for many travelers is to carry both.

12. *Letters of credit.*—The principal banks of the world issue letters of credit designed specially for the use of travelers. They are accompanied by a letter of indication (Figure 14), and are of two kinds, namely: (a) Domestic, drawn in local currency for use in the country where they are issued as, for example, dollars in America and francs in France (Figures 15 and 15a), and, (b) Foreign, now usually drawn in dollars and similar in form to Figure 15 tho letters in sterling and francs are available (Figures 16 and 16a).

The holder of one of these credits may draw any sum he desires, up to the amount of the credit, thru correspondents at all the principal places visited by

TO OUR CORRESPONDENTS:19.....
Gentlemen,

M
whose signature is to be found below, is the holder of our Travelers' Checks
as follows:

No. Xto No. Xinclusive,
of the denomination of \$10.

No. Ato No. Ainclusive,
of the denomination of \$20.

No. Bto No. Binclusive,
of the denomination of \$50.

No. Cto No. Cinclusive,
of the denomination of \$100.

No. Dto No. Dinclusive,
of the denomination of \$200.

We commend to your usual courtesies.

FOR THEBANK

.....
(This signature must agree with the
countersignature on the checks.)

SIGNATURE OF

.....
(Must be inserted at the time the checks
are purchased.)

LETTER OF INDICATION ACCOMPANYING TRAVELERS' CHECKS

FIGURE 12

.....19.....

TO OUR CORRESPONDENTS:
Gentlemen,

M
the bearer of this letter, whose signature is to be found below, has been supplied with our Circular Letter of Credit No.....and we commend.....
to your usual courtesies.

FOR THEBANK

SIGNATURE OF

LETTER OF INDICATION ACCOMPANYING LETTER OF CREDIT

FIGURE 14

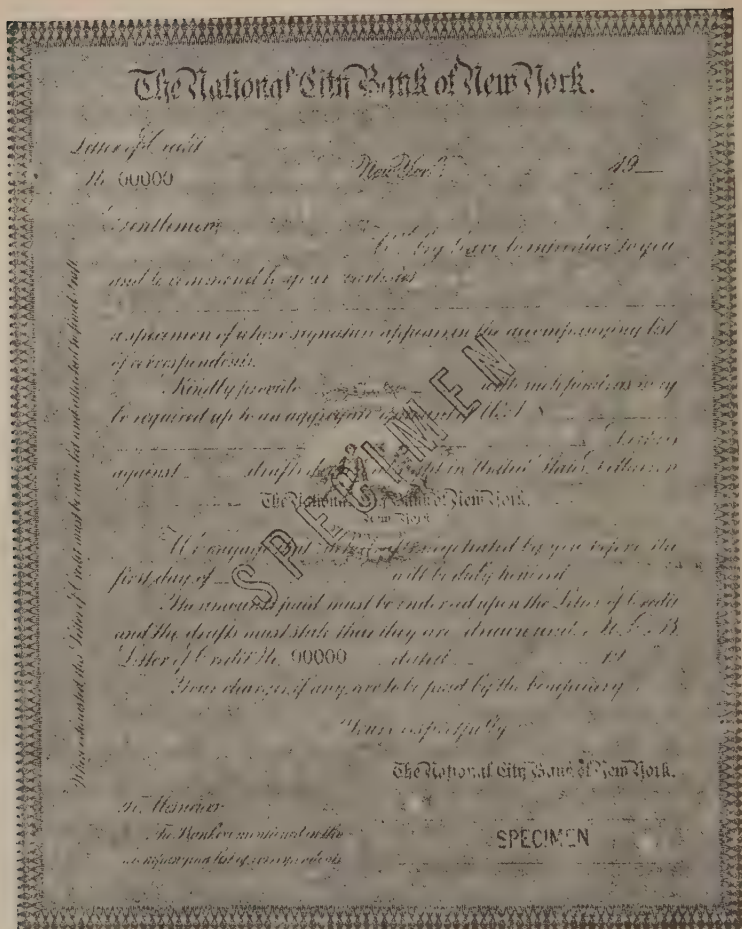


FIGURE 15. CIRCULAR (DOLLAR) LETTER OF CREDIT (FRONT)

CIRCULAR LETTER OF CREDIT

No.

£.....Stg.

ISSUED BY

THE.....BANK.

..... 19....

To the Bankers

named in our Letter of Indication.

This letter will be presented to you by

.....
..... *in whose favor we have opened a credit of*
..... *Sterling*
to be availed of by demand drafts on

The.....Bank, London.

*which we request that you will negotiate at the current
rate of the day, less your usual charges.*

The drafts should bear the following clause:—

*“Drawn under Credit No.”; they should be
drawn within one year from the date hereof, and the
date and amount of each draft cashed are to be entered
in the space provided on the back of this letter.*

*M.....
provided with a copy of our Letter of Indication,
whereon signature may be found.*

For The.....Bank.

.....
.....

CIRCULAR (STERLING) LETTER OF CREDIT

FIGURE 16

SPECIFICATION

OF PAYMENTS MADE UNDER THIS LETTER OF CREDIT

Date When Paid	Paid by	Amount in Words	Amount in Figures

CIRCULAR (STERLING) LETTER OF CREDIT (Back)

FIGURE 16a

business men and tourists thruout the world. A list of paying agents is supplied to each purchaser.

13. *Payment to the holder.*—The holder draws a draft on the central correspondent of the issuing bank designated in the letter of credit for the amount of money he requires and presents it to one of the paying agents designated in the list of paying agents. The paying agent then compares the signature on the draft with that given in the relative letter of indication and authenticates the signature of the officers appearing on the letter of credit by means of the specimens he has on file. If the signatures are in order he makes payment and enters the particulars of the draft on the back of the letter of credit.

In accordance with the usual banking custom the paying agent deducts his commission at the time payment is made to the holder of the letter of credit, but should the letter of credit request him to make payments without deduction, his commission is added to the amount of the draft when forwarding it for redemption to the branch or correspondent of the issuing bank named in the letter of credit. If the letter of credit is not drawn in local currency, the paying agent makes payment at a rate of exchange which includes his commission.

The banker who pays the draft, exhausting the letter of credit, forwards it to the central agent together with the draft for redemption.

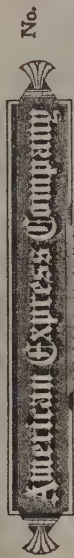
Advised or restricted letters of credit are similar in form to circular letters of credit, except that they are

advised direct to the correspondents to whom they will be presented for payment, and specimen signatures of the holder are forwarded to these correspondents, so that a letter of indication is unnecessary.

Letters of credit are available for the period specified thereon only (generally twelve months or less), and paying agents should always take care to see that this period has not expired when a letter of credit is presented to them for negotiation.

14. *Circular notes*.—Circular notes (often written in French) are similar in form, payment and redemption to travelers' checks. They are issued for fixed even amounts of a given currency (pounds sterling, dollars, etc.), and are payable at that amount without deduction in countries which use that currency. In countries where the local currency differs from that designated on the circular notes, the equivalent of the amount is paid at the current rate of exchange. Altho formerly very popular, circular notes have largely fallen into disuse. Only a few British banks were issuing them in the year 1922, and the important tourist companies had practically discontinued selling them.

15. *Foreign money orders*.—There is no cheaper, safer or more convenient means of remitting small sums of money to any part of the world than that of foreign money orders or bankers' limited checks (Figures 17 and 18). The latter have fixed limits in various currencies, the rates of exchange being determined at the time the notes are purchased in America.



No.

When countersigned by

an authorized Agent, pay this Cheque from our credit balance,

To the order of

--	--	--	--

100	80	60	40	20	U. S. DOLLARS
25	20	15	10	5	POUNDS STERLING
875	700	525	350	175	FRANCS OR LIRE
4800	3200	2400	1600	800	MARKS OR KRONEN
250	200	150	100	50	GUILDERS
400	320	240	160	80	KRONER (SCAND.)
2000	1600	1200	800	400	FINMARKS OR LEL
500	400	300	200	100	DRACHMAS OR PESETAS

ISSUED BY 1920.

GOOD TO PAY

PROVIDED the written amount DOES NOT EXCEED the HIGHEST PRINTED MARGINAL AMOUNT. THIS CHEQUE IS VOID if any alteration, detachment or modification hereon is made.

AMERICAN EXPRESS COMPANY.

To

Wm. H. Taylor
Treasurer.

State

192

COUNTERSIGNED

At

Agent.

(6017 Jan. 1920.)
SERIES B.

Figure 17. Foreign Limited Check

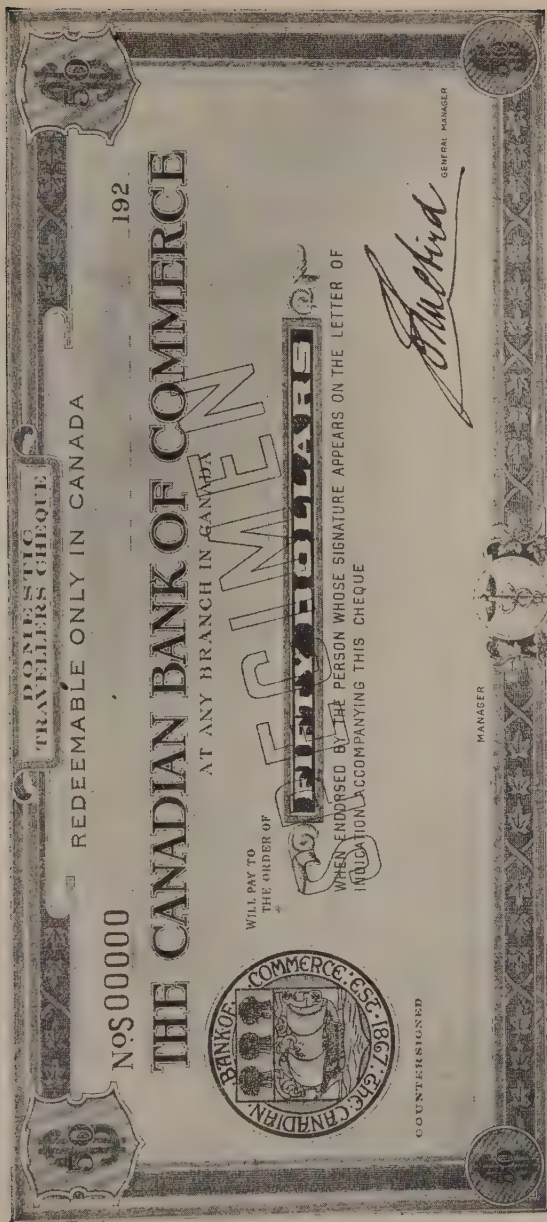


Figure 18. CANADIAN DOMESTIC TRAVELER'S CHECK

This form is representative of traveler's checks issued by all the Canadian banks. Altho they are domestic within Canada, they partake of the nature of foreign remittances when purchased from Canadian branch banks in the United States for use by American travelers in Canada. For such use they have achieved very considerable popularity.

16. *Payment of orders.*—Foreign money orders are *not* usually advised to the paying agents, but the issuing bank, as a rule, holds the paying agents of their foreign money orders free from responsibility in cashing them, provided:

(a) The money orders are drawn on the proper form.

(b) The amount of any one money order does not exceed the limit fixed by the issuing bank.

(c) The signatures of the officers on the money order agree with the specimen signatures of authorized signing officers on file.

(d) The money order is presented for payment within, say, twelve months of the date of issue. (After the expiration of this period the money orders are payable only at the head office of the issuing bank.)

PAYMENT TO HOLDERS

(a) In Great Britain and Ireland the face amount of sterling is paid to the holder without deduction except for revenue stamps if the order is drawn in sterling. Dollar orders and checks are paid at the rate of exchange for New York funds on the day they are presented.

(b) In countries other than Great Britain and Ireland the equivalent of the dollar amount is paid to the holder at a rate of exchange which includes the commission and other charges of the paying agent. In countries where a revenue stamp is necessary the

cost of such stamp is charged to the holder of the foreign money order.

REDEMPTION

(a) Foreign money orders paid in Great Britain and Ireland are redeemed by the London, England branch or correspondent of the issuing bank, at the face amount of sterling plus the commission agreed upon if drawn in sterling, or at the dollar equivalent at the rate of exchange on the day of payment.

(b) Foreign money orders paid in countries other than Great Britain and Ireland are redeemed by the London, England branch or correspondent of the issuing bank at the dollar equivalent at the rate of exchange on the day of payment.

17. *Mail remittances.*—To meet the requirements of emigrants and to facilitate the transfer of sums of money to places where banking facilities are somewhat limited, a special class of transactions, called mail remittances, has been instituted. By this system a bank in one country requests its chief correspondent in another country to pay a certain sum to a specified person in that country, and incloses a draft in favor of the correspondent to cover the amount involved and the correspondent's commission (which is usually the same as for drafts). The correspondent in the country then forwards the amount (or its equivalent in local currency) to the beneficiary by registered mail or thru its agents in the town where the beneficiary resides.

In order to make sure that the amount reaches its destination safely, the purchaser is furnished by his bank with two slips, one a receipt for the money he has paid and the other a notice (with translations thereof in various foreign languages) for transmission to the beneficiary, which instructs him (the beneficiary) to communicate with the central correspondent if the sum mentioned thereon is not received within the course of a fixed number of days. (See Figure 19)

REVIEW

What is a demand draft? Describe some of the ways in which drafts are paid.

What does a letter of advice usually contain?

How are travelers' checks redeemed?

What is a letter of indication? Why is it issued?

What kinds of letters of credit are issued? How does the holder secure payment?

When are paying agents of travelers' checks free from responsibility in cashing such checks?

CHAPTER XIII

THE SILVER STANDARD

1. *Diverse monetary standards.*—Up to this point the explanation of international exchange has assumed the existence of the gold or the gold exchange standard. In other words, it has assumed the existence of a fixed par of exchange and has endeavored to explain the various forces and tendencies which determine the variations from that par. The same forces and tendencies are operative in the exchange relations of two countries having different standards, but their working is obscured by other factors which affect the par itself.

In discussing international exchange between countries of different monetary standards the emphasis is shifted to the considerations which fix the par of exchange. How is the par of exchange determined, to what extent is it itself a variable quantity, and how do its variations affect exchange relations? It is with questions of this nature that the further discussion of exchange relations must be chiefly concerned in the consideration of exchanges with countries having a silver currency standard and with those having a paper standard of currency.

2. *Silver standard.*—A country is upon the silver

standard when its legal tender monetary unit consists of a definite quantity of silver, free coinage being permitted or, as in China, a fixed weight of uncoined silver, such as the Shanghai tael or the Haikwan tael being the commercial monetary unit. In such a country the money value of silver coins is practically the same as the commercial value of the bullion which they contain. In such countries, of course, silver and money are regarded as identical, just as gold and money in gold standard countries are thought of as being practically one and the same thing, altho coin being in convenient form is often worth slightly more.

Only one country of commercial importance is now upon the silver standard, namely, China. The subject of silver exchange, therefore, is not of great importance to the business world; as a middle term, however, between the gold standard and the paper standard, it has far greater significance in the exposition of the principles underlying exchange operations. In the nineteenth century there was a long and bitter conflict between the advocates of silver and gold, some important nations being on the silver basis, others on the gold basis, and still others on a joint or bimetallic basis, the free coinage of both silver and gold at a fixed ratio of value being permitted and the coins of both metals being legal tender. The adherents of the gold standard triumphed over their silver or rather their bimetallic opponents in the latter half of the nineteenth century, and in the

last thirty years all the important nations of the earth have sought to put their monetary systems upon the gold basis.

3. *Monetary use of silver.*—The most important use of silver is as currency and all the world is therefore interested in its price. It is the small change of the gold countries, it is usually the body of the circulating medium in the gold exchange countries, and the general currency in the countries of a silver standard, tho in both the cases last named there may be a considerable paper circulation.

4. *Subsidiary silver.*—In gold standard countries silver is used largely for the purposes of daily life and is redeemable in gold. In certain countries, as in France and the United States, the amount of such money is in excess of small change requirements and circulates thru paper representatives. The bullion value of the silver coins has no relation to the present value of silver tho it accords in the main with the value of that metal in the early part of the nineteenth century. When the weight of the coins was fixed they were purposely somewhat overvalued as compared with the price of bullion then current. It was in fact so fixed that no probable advance in the price of silver would give to the coins greater value as bullion than as money. In the last fifty years the price of silver has as a rule been much lower than that corresponding to the coining value of the metal. In the aggregate the demand of the gold standard countries for silver is a considerable one. The lower

the price of silver, the greater profit there is to the government in its issue, but it is restrained from making an undue extension of minor coinage thru the necessity of preserving its convertibility into gold.

5. *Silver currency under gold exchange standard.*—Under the gold standard silver occupies an important tho a minor place in the monetary circulation. Under the gold exchange standard silver or notes based upon silver form the money of domestic circulation. They are convertible into gold exchange only for the purpose of foreign payments, and are received at their face gold value in payment of debts due the government, and may be legal tenders at their gold value in payment of private debts.

The countries of the East continue to make large demands upon silver for monetary use. In the Philippines, Siam, French Indo-China, Straits Settlements, British North Borneo, The Federated Malay States, Sarawak, India, and the Dutch East Indies silver, with the notes based on it, is practically the only currency in use. Siam's gold standard coin is the dos (or ten tical piece), but none has yet been issued. The colonial government of French Indo-China fixes the rate of exchange between the piastre, or dollar, and the franc, thus giving the colony the gold standard of France. The Straits Settlements, British North Borneo, the Federated Malay States and Sarawak all use the same silver currency, which is maintained in a fixed ratio to the pound sterling.

In each of these countries the notes of the four Anglo-Asiatic banks, redeemable in the standard silver coins, circulate freely, and in certain places are preferred to the local paper issues which are, nevertheless, well supported and wisely administered paper currencies. The domestic trade of these countries is regulated by the bullion price of silver, but all outside transactions are based on gold. The Dutch colonies use the Netherlands silver, maintained at gold parity, as well as notes based on this silver.

The following are the principal coins used in these countries:

Name	Fineness	Grammes	
		gross	fine
Philippine Peso	800	20.000	16.000
British Dollar	900	26.9569	24.4388
Mexican Dollar	902.7	27.073	24.4388
Maria Theresa Dollar	833 $\frac{1}{3}$	28.0668	23.3889
Straits Settlements Dollar	900	20.2177	18.1958
Indo-China Dollar (or piastre)	900	27.000	24.300
Chinese Republican Dollar or "Yuan"	900	26.8567	24.171
India Rupee	916 $\frac{2}{3}$	11.664	10.692

Maria Theresa Dollar.—This is a trade coin (one without the obligation of redemption) minted at Vienna, but not used in Austria. It is current with full legal tender value in Abyssinia, Arabia, East Coast of Africa, Eritrea, Oman, Persian Gulf countries, Tripoli, and countries of the Eastern Mediterranean and Asia Minor. This coin has almost disappeared from Far Eastern circulation since 1914.

Mexican Peso.—This coin, also called "Mexican

Dollar," is full legal tender in Hongkong and China. In certain sections of China it is preferred by the Chinese to the coins minted by themselves.

British Dollar.—This coin was created in 1894 in response to the great demand for currency in the Far East. It is legal tender in Hongkong and Labuan.

Indo-China Piastre.—This coin was introduced by the French Government to help commerce in her Asiatic colonies. It is modelled after the Mexican dollar, and is accepted as equivalent to the latter coin.

Straits Settlements Dollar.—This coin was originally minted for circulation only in the Straits Settlements, but has become current in British North Borneo, The Federated Malay States and Sarawak. It was much used in Sumatra some years ago. Eventually, in order to avoid the complications of two competing currencies, the Dutch government took measures in 1907 to supply the country with the needed Dutch money current in Java and the Straits dollar was driven out. It has a fixed value of 2 shillings and 4 pence and is only given here for purposes of comparison, as the Straits Settlements are on a gold exchange basis.

Trade Dollar.—This dollar was coined by the United States to compete with the Mexican dollar in trade with China and the Far East. It had no status within the United States and has been withdrawn from circulation. Any still outstanding have only a bullion value.

6. *Chinese silver standard.*—As already noted,

China is the important country which remains strictly on the silver standard. While there is a considerable circulation of native and foreign dollars, especially in the cities and along the railroads, silver circulates chiefly by weight. The ancient unit, the tael or liang, continues to be used. A tael is actually a weight and not a coin and circulates in the form of shoes, or of small bars. There are several different units, the taels in different cities and provinces differing slightly from one another in weight and in fineness of silver. Actually there are no silver ingots of one tael; the ingots usually weigh from 7 to 10 taels and are called sycee from the Chinese "Sai ssu," meaning fine silver. In the neighborhood of Shanghai and of Peking their taels are accepted as standard and other currencies are reduced to them in large transactions, altho in those cities Chinese dollars are generally used in retail trade.

The variation in weight in the sixteen best known kinds of tael is from 37.5317 grammes of fine silver in the Hai Kwan tael to 34.0732 grammes fine in the Swatow tael. The Hai Kwan (or customs) tael is the most important. It is generally rated at 72 per 100 Mexican dollars. The official tael agreed upon by treaty is the Peking Kuping or Treasury tael divided into 100 cents of 10 mills each, for purposes of reckoning. It is not now coined tho at one time it was planned to make it the standard coin. This unit weighs 37.313 grammes .980 fine and contains 36.56674 grammes of fine silver. The Chinese mone-

tary system has been still further complicated by the series of revolutions the country has been passing thru. There have recently been issued four different mintings of republican dollars weighing 26.8567 grammes, .900 fine. The Mexican dollar also circulates freely tho it is much less common than formerly.

Some of the silver coins are stamped or "chopped." This practice arose from the fact that many light and debased coins were formerly in circulation, and having once established the value of a coin the Chinese merchant or banker marked it, not only that he might recognize it again but so that others to whom his "chop" was familiar might accept it confidently. The practice is much less common since the mints of late years have been making much better standard coins.

The customary divisions of the tael are the mace and candareen which represent certain fixed weights of silver. The weights and value vary according to location, but these divisions are little used in connection with foreign trade. In China most of the smaller domestic retail business is transacted in "cash," a coin of varying weight, size and metal. Theoretically the new cash coins are equal in value and are reckoned at 1000 cash per dollar.

In his book on "Eastern Exchange Currency and Finance," Mr. W. F. Spalding gives the substance of a newspaper article describing the experience of a traveller in China in the matter of converting silver into cash.

Altho cash are of various sizes and weight, those in modern use usually in 10 or 20 cash pieces are all of one value, with the exception of the very small and thin counterfeit coins, which have whatever worth is assigned to them locally. Commonly a cent or a "copper" is worth 10 cash and a dollar 1,000 cash: but, in practice, there is no certainty in the matter. A dollar may be worth 1,450 cash—each 100 cash consisting of eighty only, and each eighty consisting of sixty large cash and twenty small cash. At the same time, the copper may be worth anything from eight to eleven cash; the dollar may be worth from seventy to seventy-five hundredths of a tael of silver which latter may be from 90–100 per cent pure metal. The relative values are subject to alteration upon the shortest notice; they are also regulated arbitrarily from time to time by the Chinese local officials who are always ready to speculate in the cash market. In such circumstances, one can conceive the confusion which exists. It does not at all follow that the Chinese are discontented with their system: they will cheerfully spend any amount of time and take endless trouble in working out the intricacies involved in payment. If a man comes into a shop one day when 93 cash constitute a hundred and of these 93 cash 70 per cent should consist of large cash and 30 per cent small cash and he makes a 29 cash purchase, he will readily spend an hour or so arguing with the shopkeeper as to what 70 per cent of 93 per cent of 29 is; and since the Chinese have no actual system of reckoning on paper, it must all be calculated with the ubiquitous *Suan pan*, or "abacus."

In other passages Mr. Spalding speaks of the uncertainty of the tael rate, as a further factor complicating the conversion of silver into cash. He says:

Every place has its own tael weight, and some of them maintain several standards at the same time. And if, perchance, the tael weight were the same on any given day in any two centers it would be only a mere coincidence.

In addition to the weight, etc., the changing of silver is a real trial; and, to quote the newspaper previously mentioned, "Every little district has its own scale and every shop in that district differs just a trifle from every other shop in reading the scale. If one weighs out 10 taels of silver at home and then goes out to a cash shop to turn it into cash, he will find that he has 9.98 taels in one shop, 9.97 taels in another, and perhaps 9.99 in another, but never quite 10 taels. Even if he has previously been informed that silver is exchanged at 1,500 cash, he will be told that it has dropped to 1,450 cash; and that as his is only 95 per cent, he cannot possibly get more than 95 per cent of 1,450 cash on 9.98 taels. If again, he turns round in an hour and tries to buy silver with his cash, he will probably have to pay 1,550 cash for a tael and will then receive short weight on his silver."

It will be understood that the ascertainment of the value of the tael is only an approximation. If the taels of the same name were uniform in weight we should need only to ascertain the fine silver in each and apply to this weight the London quotation for standard silver or the New York quotation for fine silver. Since, however, there is a certain range of variation in the weight of the tael, authorities are likely to differ as to the average weight. This makes it almost impracticable to check up the statements of one writer with those of another except in general terms. Larger transactions with foreigners are made in some specific tael like that of Shanghai or Peking to avoid misunderstanding and uncertainty.

The monetary system established in Hong Kong and Labuan by the British Government is the silver standard and has as its base or standard coin the Mex-

ican dollar weighing 27.073 grammes (902.7 fine) or 24.4388 grammes fine silver. The British dollar (24.2612 grammes of fine silver) is treated as equal to the Mexican dollar and both are legal tender to any amount.

7. *Silver mint par*.—Before taking up the actual exchanges between the East and the West it is desirable to examine some of the more or less theoretical considerations which bear upon the exchanges between silver using and gold using countries.

When several countries of the earth were on the silver basis, exchange relations between them were determined exactly as are exchange relations between two countries on the gold basis. In the early part of the nineteenth century the United States, altho nominally on a bimetallic basis, was really upon a silver basis, for gold coins were not in circulation, being worth more as bullion than as money. At the same time many important nations of the world, such as Germany, Russia and India, were on the silver basis. In those days the mint par between the American silver dollar and the German thaler was merely a question of mathematics, being determined by the quantity of silver in the one as compared with the quantity of silver in the other. That of course is the method, as has already been explained, by which the mint par between the moneys of countries which are upon the gold basis is determined.

8. *No mint par between countries on different standards*.—When two countries use different metals

as money, each being freely coined, it is obvious that there can be no stable value relation between their coins, and therefore no mint par unless the commercial values of the two metals move up and down in absolute unison. Of course, under ordinary conditions the values of two commodities never move up and down together at all times. Hence quotations of exchange between countries on different standards cannot be comparable to a mint par.

It is worth while recalling, however, that in the old days of bimetallism prior to 1870, when many countries were on the joint standard of gold and silver, the variations in the value fluctuations of the two metals were so slight that for the purposes of international trade something like a bimetallic mint par did exist. This is a matter which has been the subject of much debate in the last fifty years, but it possesses no practical importance at the present time and therefore deserves no further discussion.

9. *Exchange par.*—While there can be no mint par between countries using respectively a gold and a silver standard, we can at any given time calculate the rate at which their currencies might be expected to exchange, and this rate might be called the exchange par. This equivalence is of course based upon the prevailing price of silver in terms of gold. If, for example, silver is worth \$1.00 per fine ounce, the Mexican dollar weighing 375.62 grains of fine silver, largely current in Eastern countries, would be worth 78.23 cents. If the price of silver should rise

to \$1.10 per fine ounce, the Mexican dollar would rise in value to 86.053 cents, or if silver were to fall to \$.90 per ounce, the value of the Mexican dollar would be 70.407 cents. Eastern exchange on New York for Mexican dollars would tend to conform in the main to the equivalents here noted when silver stood at the respective prices here assumed. In practice we should have to take cognizance of the fact that exchange is quoted in Shanghai and silver prices in New York and make allowance for it, but the foregoing explanations are intended only to make clear the nature of an exchange par.

What we have done here is strictly similar to the calculation of a gold unit par which it will be remembered expresses the relation between the amounts of fine gold in the coins of two countries. In the present instance we find the weight (or value) of a quantity of gold representing the gold value of the silver unit, and establish its relation to the weight (or value) of the gold unit. Inasmuch as the gold value of the silver unit varies with the gold price of silver we have to do with a variable instead of a fixed parity.

In the case of two gold using countries a knowledge of the mint par together with a knowledge of the method of quoting exchange whether direct or indirect enables one to observe with little difficulty whether exchange is at a premium or a discount. Exchange quotations in the press frequently facilitate this comparison by printing the pars of exchange

as well as the rates. Variations in the latter are determined exclusively by commercial conditions, using that term in the broadest sense to include the manifold relations involving interchange of values between nations. When exchange is quoted between a silver country and a gold country the meaning of the quotation is obscured by the intrusion of the currency factor.

The fact that the exchange parity varies with the price of silver does not deprive it of its usefulness in judging the position of exchange. The published quotations, which for example in the case of China are based upon telegraphic transfers from Shanghai to London or New York, express the concurrent working of commercial conditions and of the currency factor. The calculation of the exchange parity eliminates the currency factor and enables us to judge whether the exchange is high or low. It is obvious that such calculations as were suggested in a preceding paragraph might be made once for all and set up in tables for ready reference. Such tables of exchange equivalents for different Eastern currencies have in fact been prepared for the use of British bankers who are in constant relations with the Eastern exchange market. The available tables calculated some years ago relate to pre-war conditions and to the range of silver prices current at that period. A section of a table shows, for example, the London price of silver and the equivalent values of the Shanghai tael as follows:

Silver in London	Shanghai tael	
d.	s.	d.
31	3	0 ⁵ / ₈
31 ¹ / ₄	3	0 ¹¹ / ₁₆
31 ¹ / ₂	3	1 ¹ / ₄
31 ³ / ₄	3	1 ¹ / ₂
32	3	1 ¹³ / ₁₆
32 ¹ / ₄	3	2 ¹ / ₈
32 ¹ / ₂	3	2 ⁷ / ₁₆
32 ³ / ₄	3	2 ¹¹ / ₁₆

In the table finer shadings are given for the price of silver but the foregoing will serve for purposes of illustration.

Silver is priced in London at so many pence per ounce British standard, .925 fine; it is bought and sold in Shanghai on the basis of fine silver. This is allowed for in the calculation, which takes cognizance also of the fact that the Shanghai equivalent of a given price in London must take into account the necessary charges in transferring silver from the latter point. We thus arrive at equations for the different silver standards each of which consists of a number of constants and one variable, the price of silver. Calculations are facilitated by ascertaining for each type of currency the product of the constant factors which become known as "the constant" for the particular standard. The constant so ascertained is readily applied to any given price of silver.

10. *Fluctuating pars of exchange*.—It should be obvious that when in this manner the currency factor enters into the exchange rate the fluctuations in ex-

change from day to day are likely to be greater than when this factor is absent. Thus it frequently happens that within as short a period as a week there is a variation between the highest and lowest point of Shanghai exchange that amounts to 2 per cent. There is generally a like difference between the maximum and minimum price of silver. On the other hand, exchange with Japan will not ordinarily vary within so short a period as much as 1 per cent.

More important of course are the fluctuations which occur over more extended periods. The following table shows the New York price of fine silver and the quotation of the Shanghai tael for the average of June in the years 1915 to 1920 and on June 15 from 1921 to 1928.

Date			Price of Silver per fine ounce in New York	Market quotation Shanghai Exchange (Taels) in New York
			cents	cents
Average	June	1915	51.0	56.50
"	"	1916	68.1	72.00
"	"	1917	87.5	90.36
"	"	1918	107.1	113.50
"	"	1919	118.1	127.00
"	"	1920	90.0	101.00
June	15	1921	58.375	65.89
"	"	1922	71.875	79.88
"	"	1923	65.50	72.59
"	16	1924	67.00	71.40
"	"	1925	69.11	76.13
"	"	1926	65.48	72.55
"	"	1927	56.77	63.04
"	"	1928	60.02	66.00

The first and second columns of the table reveal wide fluctuations in the price of silver and in Shang-

hai exchange in a period of 13 years. While exchange follows the silver price its fluctuations do not correspond exactly to it. For this reason the third column has been computed. The only difficulty in making this computation rests on the uncertainty as to the weight of fine silver in the Shanghai tael. Among six different authorities consulted the computed weight of fine silver differed from a minimum of 1.07589 ounces to a maximum of 1.1783 ounces. In this situation resort was had to banking practice and the figure used in the foregoing computation was based on the statement of the International Banking Corporation that the Canton tael contained 1.208 fine ounces and on the practice of London bankers of reckoning 111.2 Shanghai taels as the equivalent of 100 Canton taels. To the result thus obtained one per cent was added to secure the Chinese equivalent of silver prices in New York. This represents approximately the cost of transporting silver from New York to Shanghai.

The position of exchange, independent of the price of silver, can best be understood by a comparison of the second and third columns of the table. There is not sufficient accuracy in the calculation of the par to render it an exact measure. Nevertheless the figures serve to show that exchange may be above or below par, whether the price of silver is high or low. It is on the basis of calculations similar to this, tho varying in minor detail, that the exchange banker forms his judgment of the position of exchange.

11. *Silver specie points*.—The reader is already familiar with the gold points and their relation to exchange and knows in a general way the method by which they are calculated. For any given price of silver in the New York or London market there are corresponding export and import silver specie points which are strictly analogous to the gold points. In other words they are points where the shipment of silver becomes equally profitable with a purchase or sale of exchange at prevailing silver prices. The elements which enter into the calculation as in the case of gold shipments are the expenses of shipping and disposing of the silver and the loss of interest during the shipment. The spread between the exchange par and the shipping points is greater than in the case of gold—first because the distances are greater, affecting freight, insurance and interest, and second because of the speculative element of possible variation in the price of silver. The methods of determining the silver shipping points are highly complicated and need not detain us in this general discussion of the principles of foreign exchange.

12. *Fluctuating exchange at short range*.—The outstanding fact in this discussion which cannot be too strongly emphasized is the instability of exchange. This cannot fail to cause difficulties for the country having the fluctuating standard, and reacts unfavorably upon all who have dealings with it. The conclusions of the Commissions on International Exchange appointed by the leading nations in 1902–03

were unanimous on this point, tho not all of them were equally hopeful of attaining stable exchange.

The evils of fluctuating standards of value have been so frequently depicted that no more than a passing notice is required. Whether the fluctuations occur in domestic dealings or in foreign transactions their effects are similar, tho in the latter instance they are more restricted in their operation. We have already seen that variations in the silver exchanges are greater from day to day than in gold exchanges and that from year to year very marked changes may and do occur.

If we consider first the effect of these exchange fluctuations upon current transactions it is obvious that they act as a damper upon enterprise. They introduce an element of uncertainty into all transactions. Take for example the case of the importer in China who buys goods in the United States against a four months' draft. The goods and the draft are priced in dollars. If silver falls in price he requires more of it to meet his obligation, and he may sustain a loss. If silver rises in value he needs a smaller sum to meet his draft and makes an unanticipated profit. It is assumed in this instance—and it is usually the case—that there has been no change in China in the silver price of the goods from the proceeds of whose sale the importer meets his draft. On the other hand consider the position of the Chinese exporter who is paid in gold for his goods. If silver falls he receives in return a greater quantity of local purchasing

power, but if it rises his return falls below his anticipations.

In these illustrations we have taken the case of the Chinese merchant. It would appear that converse effects would be realized by the dealers in the United States. Such would in fact be the case where the latter priced their sales and purchases in silver. But as a matter of practice they usually make their bargains in gold and throw the risk of exchange on the merchant in China, who may of course be either a native merchant or a foreign trader residing there.

An actual illustration cited by the late Charles A. Conant in an article in the *North American Review* will serve to emphasize the significance of these current changes in the price of silver.

In trade between gold and silver countries either the exporter from the gold country or the importer in the silver country run serious risk of finding his profits wiped out by a fall in the gold value of silver. If a consignment of merchandise worth \$1,000 in gold had arrived in Shanghai in July 1902 where the prices of silver was $24\frac{3}{16}$ d. to $24\frac{9}{16}$ d., it would have brought in silver about 2,310 Mexican dollars. A gold bill of exchange for the settlement of the invoice would have cost this amount to the Chinese importer or to the foreigner carrying on an import business in China. Only four months later, in November, 1902, silver fell to a minimum of $21\frac{5}{16}$ d., and it would then have cost about 2,700 Mexican dollars to buy a bill of exchange on London sufficient to settle the invoice. If the importer in China had in the meantime sold his goods at an estimated profit of 10 per cent on the silver price of July, he would have found 2,540 Mexican dollars in his hands, or less by 160 dollars than the amount required to pay his invoice. Thus, he

would be not only without profit, but would be a heavy loser in interest on his money and in the costs of distributing his goods.

13. *Long range fluctuations.*—Not a little of the discussion of the evils of fluctuating exchange is concerned less with the variations from week to week and month to month than with the long continued fall in the price of silver which was not halted till the period of the Great War. The arguments for the adoption of a gold standard in China are based largely upon these major changes in the value of silver.

Thus the untoward effects of the fall of silver are explained from the standpoint of the investor. It is assumed that a British investor has put his money into Chinese railways. The return on his money dwindles every year under a continued fall of silver. A withdrawal of his capital thru the sale of his bonds means a sacrifice of principal and this sacrifice grows larger as silver falls.

A banker in China quoted by the Commission on International Exchange uttered this wail:

The drop in the sterling value of the tael affects us all, foreigners and Chinese Government alike, more or less. The exporter makes larger profits in taels. The importer finds his business deserting him or only possible at a loss or a very moderate profit.

The salaried man and the clerk who are paid in the currency of China find their salaries very seriously reduced when converted into sterling. It is all very well to say one can still live cheaply in China and that the tael will buy almost as many comforts as of yore. Granted that the pur-

chasing power of the tael in China has not decreased as rapidly as exchange has fallen, the foreign residents of China almost without exception are not here to live and die. We all desire to return home when the opportunity comes, and many of us have present obligations to fulfill in sterling.

Less striking perhaps in form, but equally impressive in substance, was the testimony given in the same year by Sir Robert Hart the experienced inspector-general of the Chinese customs.

It would be much wiser for China to maintain a gold standard instead of a silver one as at present, since silver has dropped down to such a degree and moreover possesses no certain or uniform exchange even within the limits of a single day. The hundreds of trades are all disastrously affected by the present state of the currency, while the Government having to pay its foreign debts in gold, both country and people are being plunged in financial distress.

14. *Alleged advantages of fluctuating standards.*—As a rule the natives of silver countries have been slow to perceive the disadvantages of their monetary standard. Changes in local silver prices of commodities have not been conspicuous and during the long fall in the price of silver it apparently retained its full purchasing power in local trade. Under these circumstances export trade seemed to be stimulated. India was at that time on a silver basis and her general level of prices did not undergo great changes. As the price of silver fell, it was possible for English importers of wheat to import that commodity from India at constantly lessening expenditures of gold. During this period the farmers of the United States,

inspired by the advocates of the free coinage of silver, complained bitterly because the price of a bushel of wheat was being steadily forced down by competition with a country which had the advantage of being on the silver basis.

* Speaking of the arguments in favor of the use of silver which were drawn from the experience of India, Dean Joseph French Johnson in his "Money and Currency" says:

To business men, as well as to farmers and producers generally, the silver advocate addressed an argument based upon the apparent prosperity of India. India had become our chief competitor in the wheat markets of the world. Until 1893, her money had been silver, and the friends of silver held that the wheat growers of India, on account of the falling price of silver, had been able to undersell the farmers of the United States at Liverpool year after year, without themselves making any change whatever in the price of their wheat. The Indian exporter of wheat, who sold it at from three to four rupees per bushel in 1873, had averaged the same price during the full twenty years, and with the money he had received he had each year been able to buy about the same quantity of goods or pay the same amount of debt, for general prices did not rise in India prior to 1893. But four rupees of silver after 1873 represented a lessening amount of gold, so that an American farmer, in order to compete with the Indian producer, had been obliged to lower his price year after year. Thus, when the price of silver had fallen until a rupee of 165 grains of pure silver was worth only 30 cents in gold, the American farmer, in order to compete with Indian wheat at three rupees, was obliged to sell his wheat at 90 cents. The advocates of the free coinage of silver, using illustrations of this sort, argued that the adoption of the silver standard would give us a tremendous advantage over foreign nations using gold as

money. The free coinage of silver would not only have the effect of a protective tariff, lessening our imports of foreign goods but would also stimulate our exports by giving our producers an advantage like that which the producers of India had enjoyed.

As for the argument based on India's apparent command of the wheat markets of the world after 1873, that also contained several grains of truth. If two competing countries are using different monetary standards, say silver and gold, a change in the value relation between the two metals will give a temporary stimulus to the exports of that nation whose money metal is falling in value with respect to the other. This stimulus is due to the maladjustment of prices that always accompanies a change in the value of a money metal. Whenever the value of silver falls in Europe or the United States because of an increasing supply or diminished demand, the decline is indicated by a fall of the gold price of silver before the general price level in silver-standard countries has been much affected. Before 1893, for example, a decline in the price of silver in Europe could not affect prices in India until additional silver had been added to India's money supply and put into circulation among the people. Consequently, when the gold price of silver fell because of a fall in the value of that metal the producers of India were under no inducement on that account to charge higher prices for their goods, for their money costs of production had not increased. An ounce of silver meant as much to them as it had meant before the decline of the London or New York quotation for silver; but since it now took less gold to buy an ounce of silver, it was possible for Europeans to buy a given quantity of India's products with less gold than formerly. In consequence American and European producers who were competing with Indian producers were obliged to lower their prices, altho the only cause therefor seemed to be a change in the relation between gold and silver.

Such a condition would of course be temporary unless the fall in the value of silver were continuous. India would in-

crease her exports until a balance had been created requiring an importation of silver sufficient to raise her price level to parity with the value of silver in Europe and the United States. Thus when the value of silver was falling India's exports of goods were always a little larger than they otherwise would have been, the excess representing the value which India gave to the world in payment for the additional silver required in her circulation.

When the gold price of silver fell because of a rise in the value of gold, as most commonly happened between 1873 and 1893, the effect upon India's export trade was more apparent than real or permanent, and was due to the maladjustment of prices in gold-using countries. When the gold price of silver changes it is commonly assumed in gold-using countries that the value of silver has fallen, and in silver countries that the value of gold has risen. So whenever the gold price of silver fell after 1873, whatever the cause, the first effect was always the same, namely, importers in gold countries were able to get goods from India by the expenditure of less gold than before the fall, and consequently American and European producers in competition with India were obliged to lower their prices. But when the change was due to a rise in the value of gold, the value of silver not declining, there was no reason why India should import an unusual amount of silver, for India did not then need any addition to her money supply. Nevertheless the exporters of India had a temporary advantage in the world's markets. Without any sacrifice they were able to cut under the gold price which had prevailed for the same goods. But their advantage could be only temporary, for prices in the gold countries, since gold was increasing in value, soon fell to a level which placed the European and the American exporter on a par with the Indian exporter. Any long delay in the adjustment of prices in gold countries would continue India's advantage and give her an unusual balance of trade, but the resultant importation of silver would lift her price level and so deprive her exporters of their advantage over exporters in gold countries. In fact such an importation of silver would

put Indian exporters at a disadvantage for a time and perhaps cause an exportation of silver.

15. *Silver exchange rates.*—The usual quotations for Eastern exchange are for the Shanghai tael and the Hong Kong dollar, and represent in London, sterling values and in New York dollar values of the Eastern units. In London the quotation is based on telegraphic transfers. Thus on July 1, 1926 the London quotation was Hong Kong 2s., 3 $\frac{1}{2}$ d. and Shanghai 2s., 11 $\frac{5}{8}$ d. On the same day in New York exchange was quoted on the basis of bankers' checks (sight drafts of bankers) as Shanghai \$.72 $\frac{1}{2}$ and Hong Kong \$.55 $\frac{1}{2}$. The Federal Reserve Board also certifies daily at noon the buying rate for cable transfers in New York. It reported on July 1: Shanghai tael \$.7214 and Hong Kong dollar \$.5523.

To interpret the significance of these figures we must know the price of silver. It was 30 $\frac{1}{4}$ d. in London and 65 $\frac{5}{8}$ cents in New York, corresponding to pairs of exchange for Shanghai of 3s., 1 31/32d. in London and, in effect, \$.77 in New York.

It has already been noted that the commercial quotations give no clue to exchange parity except to those accustomed to observe the price of silver and to estimate its proper relation to Eastern exchange. This parity varies from day to day, from month to month, and year to year with the price of silver. This is then the dominant feature in the exchange situation.

Frequent allusion has been made to it, but it will be well to consider somewhat in detail the vicissitudes of the price of silver.

16. *Price of silver before 1872.*—In studying the price of silver we may usefully distinguish three periods: the first terminates in 1872, the second comprises the years 1873 to the opening of the Great War in 1914, while the third runs from 1915 to the present time.

During the first of these periods the gold value of silver was fairly constant. In a table of annual prices presented by Mr. Spalding the maximum annual average price recorded between 1833 and 1872 was $62\frac{1}{16}$ d per ounce and the minimum, $59\frac{3}{16}$, representing in this entire period a spread of $3\frac{1}{4}$ d per ounce.

This period was not without its problems of foreign exchange growing out of the relative value of gold and silver, and they were in fact very interesting aspects of monetary theory. But if important in kind, they were comparatively trivial in degree and their effects upon commerce and other international relations were far less important than those wrought by the changes of later years.

17. *Falling silver prices.*—Beginning in 1873 and continuing thru 1914 the price of silver fell from its former high estate of $59\frac{3}{16}$ d. per standard ounce to $25\frac{1}{4}$ d. per standard ounce. The values of the English prices have been translated by the Director of the Mint into dollar equivalents per fine ounce, and these

figures are probably more convenient for the American reader. The initial value of \$1.29769 in 1873 became in 1914 \$.55312. The progress downward was not wholly uninterrupted in the period of forty-one years, there were fifteen years when the price was higher than in the preceding year. Rarely, however, were these rises in price consecutive, tho from 1902 to 1906 the price rose from \$.52795 per fine ounce to \$.67689 per fine ounce before a fall again set in.

The interlude of rising silver prices which culminated in 1906 gave rise to many currency and exchange difficulties in countries which like India and the Philippines had attempted to adjust their currencies in relation to gold upon the basis of prices previously prevailing. The following chapter on the "Gold Exchange Standard" will discuss these matters in greater detail.

In general, however, the entire period had a marked downward tendency and was at the same time characterized by a considerable fluctuation of silver prices from month to month. It gave full scope therefore to all the difficulties which surround foreign exchange on a fluctuating basis, both those which characterize short-term operations and those which affect international investment and similar transactions of greater duration.

18. *Course of silver after 1915.*—The Great War which in so many respects reversed the ordinary currents of economic life brought with it a convulsive movement in the price of silver. Beginning with

August, 1915 silver rose in price until January, 1920. In the former month it sold in New York at 47.16 cents per fine ounce and in the latter at 132.83 cents. For three months, December, 1919 to February, 1920, silver had an average price greater than the coining value of the standard silver dollar which is \$1.29 per fine ounce.

During the period of rising prices international relations with the East underwent rapid and profound changes. A renaissance of silver seemed to be impending and there were many who looked forward to silver resuming its traditional place in the monetary systems of the world. However, the early part of 1920 brought a break in the price of silver and in December of that year it had reached an average price of 64.78 cents. This was about its average price from that time to December, 1924, tho in this period the monthly average at times fell slightly below 60 cents and at times rose slightly above 70 cents per fine ounce. •

If we follow the fluctuations of the price of silver in detail we shall find the underlying cause of the changes sketched above not in any circumstances peculiar to silver but to the influences affecting the prices of commodities generally during this period. The accompanying diagram shows in ratio ruling, so that the movements of the several lines can be conveniently compared, the highest price of silver in London in the first month of each quarter from 1915 to 1923, and for the same months the average price of

silver in New York and the index number of prices in Great Britain as computed by *The Statist*.

A comparison of the lines in the diagram shows that they are approximately parallel. Silver prices in London followed the general price movement, tho from January, 1919 they rose somewhat more rapidly than did prices in general, reaching their highest point somewhat earlier. When the fall in prices began silver fell at first more rapidly than general prices, but after the beginning of 1921 it fell more slowly.

The comparison between London silver prices and New York silver prices does not reveal so close a parallel. The proportional rise in price, culminating in the diagram in January, 1920 is not so great in New York as in London, nor are the changes after that date so abrupt. This may be due in part to the different bases on which the figures are computed but it is largely explainable by the fact that British prices for silver during this period were not on a gold basis, and, therefore, reflected the depreciation of the pound sterling as evidenced by the premium on gold and the low rate of exchange on New York.

To examine minutely at this point the causes for the general price changes here noted or to point out the reasons why the price of silver departed in its movements from the general course of prices would lead us too far afield. Some of the facts which are pertinent to the rise in price are a diminished production of silver, an increased demand for silver as

subsidiary coinage to meet the expenses of military operations particularly in Eastern countries, reflected in the feverish activity of the British Mint, and the unusual demand for Eastern products. Factors in the subsequent fall of prices were the cessation of these unusual demands at the conclusion of hostilities, and the increase of available supplies thru borrowing from the currencies. The melting down of subsidiary coinage in some European countries and the operation of the Pittman Act which released large quantities of coined silver from the United States Treasury materially added to the supply of silver.

It has already been noted that for a few months the price of silver was above the melting point of the American standard silver dollars and came close to that of the subsidiary silver. At a much earlier date the price passed beyond the nominal value of the coins of European countries which were measured in a depreciated paper standard. This fact closed the mints of Europe generally to the coinage of silver, diminished the demand, and increased the supply by throwing coins out of circulation and into the bullion market.

19. *Exchange difficulties.*—It is not necessary to explain in further detail the effects of these changes on Eastern exchanges. As we have already seen, exchange rates follow the price of silver and share the instability of those rates. If in the past few years they have attracted less attention than the minor

fluctuations of the first decade of the twentieth century, it has been because they have been overshadowed by the more important problems of European exchange under the abnormal conditions of recent years.

All the ill effects of unstable exchange may be fully recognized but it is quite possible to exaggerate their importance. If the transactions of merchants were isolated the full effects of the exchange situation would fall heavily upon the individual trader. But with the existing organization of the exchange market they are reduced to a minimum. If we revert to the case explained by Mr. Conant and cited in a previous paragraph it is clear that the losses to which the trader appeared to be exposed could have been averted if he had made a future contract for his exchange as is in fact the custom with the more conservative traders. It is true that he would likewise have foregone the possible gain. But as a trader he need not be, unless he so desires, a speculator in exchange when the exchange market is well organized altho in fact speculation is rife in these countries, many traders enjoying this speculation more, and giving it more time and attention than their real trading business. A banker in turn with whom the conservative trader makes his contract protects himself by availing himself of the "future" market for silver in London, and by balancing purchases and sales may avoid exposing himself to loss.

REVIEW

Describe the use of silver as money under the gold, gold exchange, and silver standards.

In what parts of the world does silver play the dominant rôle in currency matters?

Explain how in the absence of a mint there can be an exchange par between silver using and gold using countries and how it is calculated.

Describe the inconvenience of a fluctuating exchange par as it affects (a) current transactions and (b) government indebtedness.

Review the changes in the price of silver in the last hundred years.

How does an organized exchange market serve to mitigate the inconveniences for current transactions of fluctuating silver prices?

CHAPTER XIV

GOLD EXCHANGE STANDARD

1. *Outgrowth of silver standard.*—Allusion has been frequently made in these pages to the gold exchange standard, and the time has come to examine somewhat in detail this system of currency. The reader has inferred that in the matter of influencing exchange rates the gold standard and the gold exchange standard were practically identical and this is the case where the latter has been successfully established. Apart, however, from the matter of foreign exchange the gold exchange standard is more closely related to the silver standard than to the gold standard. It represents an effort to escape from some of the disadvantages of the silver standard while retaining silver in use, and since we must understand what those disadvantages are before we can appreciate the significance of the remedy for them, the discussion of the silver standard in the preceding chapter was a necessary preliminary to the consideration of the gold exchange standard.

The latter is essentially a compromise. Viewed from the standpoint of foreign exchange it appears as a variant of the gold standard; viewed as a currency system it appears, as we shall see, as a modification

of the silver standard. It is obvious that the two separate elements of which it is compounded must first be understood before we can comprehend the mixture.

Essentially the system is one which provides silver for internal use, altho at a gold valuation, and gold or its equivalent for external use. The silver currency in use is always convertible at substantially a fixed rate into gold exchange in all international relations. The mechanism by which this is effected will appear later.

2. *Silver and gold using countries.*—Silver is the traditional money metal of the world and gold, so far as it had a monetary use, was for centuries regarded merely as supplemental to it. After the discovery of America, gold assumed larger importance in the Western world and was used as currency concurrently with silver. With the break up of the so-called bimetallic par in the second half of the nineteenth century, a clear division appears between the gold standard and silver standard countries.

It was practically a division between West and East, for the Asiatic nations clung to the monetary use of silver and only recently have accepted a modified use of gold for currency purposes. At the close of the nineteenth century practically all of the nations of the East were upon a silver standard as China is today. It was out of this situation that the gold exchange standard was born.

3. *Silver in domestic use.*—Despite all that has

been said of the disadvantages of the silver standard it must be confessed that the natives of Asiatic countries where silver currencies prevailed were scarcely aware of them. Customs change slowly in those countries and their needs for domestic purposes seemed to be met about as well as before. Prices it is said changed little. Indeed there were not lacking those who contended that dwellers in the East with comparatively stable prices were better off than the denizens of the West where for many years prices were falling. It is not to revive the questions debated with so much vigor in the nineties whether silver had depreciated or whether gold had appreciated that these matters are mentioned but merely to call attention to the fact that gold and silver differed. Those who placed themselves on the standpoint of gold as did the people of Western nations were prone to conceive of it as unchangeable and it is natural that those who placed themselves upon the standpoint of silver should assign a like immutability to the standard in which they were accustomed to measure values.

4. *Silver in external affairs.*—Silver and gold went their separate ways and so long as their ways did not cross no trouble ensued. Fluctuations in the price of silver as it appeared to Western eyes, or fluctuations in the price of gold as the Oriental conceived it, made trouble wherever it was necessary to change silver into gold or vice versa. As we have seen in the previous chapter it meant fluctuations in

exchange, a source of constant embarrassment to those concerned in such operations. As above noted the great bulk of the people both in Europe and in Asia appeared to be entirely unaffected by these changes. But there were various groups and individuals to whom such fluctuations in exchange portended losses.

There were first of all the governments concerned. Eastern nations had borrowed heavily in European markets and had large interest payments to make in gold. They were adversely affected when it required increasing amounts of silver, in which their revenues were received, to make these payments. The cases of the European investor in Eastern securities, the foreign trader resident in the East, the Government officials and mercantile employes domiciled there and receiving compensation on a silver basis have already been alluded to. When their compensation was on the gold basis they made large gains since their gold salaries brought them more silver, while their living expenses based on silver prices underwent little change. It is obvious that these individuals would have been of little influence in bringing about any change in the situation if they had not been backed by powerful governmental interests.

5. *Gold standard solutions.*—Some years before, when the price of silver began to diverge from its traditional relation to gold, the nations of the Western world met the situation by the general adoption of the gold standard, relegating whatever silver money re-

mained in use to the position of token money. This lessened demand for silver and increased demand for gold tended strongly to increase the divergence in relative values. But such a solution was not applicable to the East. Silver was too firmly entrenched in the habits of the people to be thus thrown into the discard. To have done so would moreover have made such a drain upon the world's gold resources as to have caused serious embarrassment to the gold standard wherever it might be found.

Some analogies applicable to the situation seemed to be found in the countries having a gold standard with a large amount of full legal tender silver money in circulation, such as France and the United States and especially Holland where silver was not legally redeemable in gold but was maintained at parity. If such countries could successfully maintain this situation, could it not under proper safeguards be further extended to the point where a gold standard was maintained without gold currency and with a circulation composed exclusively of silver or equivalent note issues? This was the question which lay back of the proposals to establish a gold exchange standard.

6. *Diversity of money functions.*—The problem stated emphasizes the fact that money in different situations performs diverse functions. It is obvious that one kind of money may serve as a medium of exchange while another kind of money serves as a standard of value. However important the international function of money may be, it represents for example

in a gold standard country only a minor part of the varied uses to which money is put.

The service of money in international relations is as we have seen merely the adjustment of balances of payment, and these balances form only a small proportion of the total foreign trade. Moreover it is well known that the volume of foreign trade as a whole bears usually only a small proportion to that of domestic trade.

If then sufficient gold could be accumulated to make it possible to secure gold or its equivalent for the purposes of international commerce at a fixed ratio to silver, the latter metal might well continue to be the currency of daily affairs. This is what the gold exchange standard proposed and what it has in large measure effected.

7. Mechanism of the gold exchange standard.—The gist of the gold exchange standard is that the government, either directly or acting thru a bank, becomes the regulator of the exchange market. In other words it offers to buy and sell foreign gold exchange at substantially a fixed rate compared with the silver currency of the country. To use an expression borrowed from other circumstances it “pegs” exchange at a certain point.

For this purpose it keeps a gold reserve abroad and often some gold also at home. Inasmuch as these gold exchange standard countries have usually been colonies or dependencies, the chief gold reserve has been kept in the home country. The gold reserve

has been obtained usually in the first place by the sale of government securities. Later it has been augmented by the profit from seigniorage of silver coins, from the premiums in selling exchange, and possibly in certain instances from other special sources of revenue. In case of emergency, the fund might be added to by selling further securities. In order to maintain the parity of the token standard silver coins or of paper with gold, the government either directly or thru its national bank offers to sell on demand gold exchange against the gold reserve fund to be paid for with the standard coins or paper. The rate charged is, of course, the rate determined by law for the value of the token silver coins or paper, plus a very slight exchange premium rate, substantially enough to cover the cost of gold shipment.

The silver or paper currency thus paid in for exchange is not put again directly into circulation, but is held in the vaults. In case the contraction of the currency thus brought about becomes in any degree excessive, the government agrees to purchase gold exchange on demand at the fixed rate plus a small exchange charge, and to give in payment therefor the silver token coins or the paper. In this way it replenishes the gold fund and expands the currency correspondingly.

It will be noted that this partial convertibility of silver into gold, tho only for limited purposes, definitely aligns the country adopting this system with the gold standard countries. It will be noted also

that the plan definitely divorces the purchasing value of the silver coins in circulation from their bullion value, making them token coins. Free coinage of silver bullion is suspended and coinage on government account takes its place. Silver currency is regulated in its purchasing power by its coining value and not by its bullion value. Prices thereafter will respond in the main to changes in the value of gold rather than changes in the value of silver. It is the shadow rather than the substance of gold which guides monetary relations, but its influence is no less real.

8. *Valuing silver*.—The value assigned to silver under this system cannot be chosen arbitrarily. Due regard must be had to the habits of the people and the condition of the market. Assume that there is a uniform circulation of silver coins—a condition not frequent in the East where the actual circulation is often composed of varied elements. Fixing the exchange value of the coin with reference to gold does not disturb in any way its local use so long as its nominal value is greater than its bullion value. But the difference between the two cannot be large without offering temptations to counterfeiting. The vigilance of governments has in the main been effective in preventing extensive counterfeiting of minor coinage in western nations. In eastern nations where men are accustomed to work laboriously for smaller margins of gain it is open to question whether a like result could be expected. In some cases a coinage or valuation ratio only a little below that prevailing

in the bullion market has been adopted, in others the risk of extensive counterfeiting has not deterred governments from adopting coins of from 20 to 30 per cent less fine weight than the current price of bullion would require.

All goes merrily so long as the bullion market remains comparatively stationary. But let the price of silver rise and trouble ensues. Should the price of silver rise to such a point that the currency instead of being overvalued is undervalued it would be profitable to melt the coins and export them as bullion. To some extent this could be prevented by prohibiting the export of silver, but such restrictions are ineffective when the prospects of gain thru smuggling are attractive to venturesome men. If this contingency arises there is danger of a loss of currency which means not only a disturbance of domestic monetary conditions but a financial loss to the government.

Whether the government will under such conditions rely upon temporary expedients or whether it will make the currency "safe" by reducing its silver content becomes a grave problem only to be solved successfully by forecasting accurately the future relation of silver to gold. The experience of the Philippine government in such a situation is narrated in a later section.

9. *Keeping the gold reserve intact.*—The other problem in the maintenance of the gold exchange standard is that of keeping a gold reserve adequate to meet all demands upon it. Normally of course

over any considerable period of time exports and imports of a country tend to balance one another. From year to year the disparity between the two is not likely to be great. However, it must be understood that foreign trade is based upon current and not upon annual settlements. It frequently happens that during one period of the year the current of payments will be outward and in another period inward. It is for such seasonal fluctuations that the gold reserve must in the main provide, tho of course emergencies may and do arise when the drain upon it will be more severe.

10. *Indian currency experience.*—Perhaps the most widely known exemplification of the principles of the gold exchange standard was given by India. Technically it might be more correct to speak of India as having a gold standard. Enough has been said in this discussion to show the reader that the gold standard is in a certain sense a matter of degree and that countries having such a standard absorb in practice varying proportions of gold for monetary purposes. In the case of India the gold standard has been formally adopted but the use of gold coin except for purposes of foreign exchange is so limited that the currency approximates the gold exchange standard.

Up to 1893 India was on the silver standard and as we have seen in a preceding chapter underwent all the disadvantage of that situation and also drew a certain profit from it. Relations with western

countries were, however, in the case of India much more intimate than in that of other eastern countries. The government and the official classes shared in a high degree with the mercantile element the disadvantages of falling silver prices.

In 1893 the mints of India were closed to silver, and the value of the rupee was fixed at 1s, 4d or in the ratio of 15 rupees to the pound sterling, British gold coin was made legal tender in India, and rupees were made exchangeable for it but not vice versa. Actually from that time to the present comparatively little use has been made of this convertibility for internal purposes, and the actual circulation of gold in internal business has made little progress.

To return to the rupee it may be noted that the valuation fixed in 1893 was based upon the exchange rates which had prevailed in the years immediately preceding the closing of the mints. This action gave to the rupee a scarcity value and provision was made to prevent this feature becoming embarrassing by reserving to the government the right to coin rupees at its discretion.

The action of the Indian Government was avowedly tentative. Its purpose was not to enhance the value of the rupee but to steady it. With this end in view the convertibility of the silver into gold was maintained at home and abroad—at home by giving rupees in exchange for gold; abroad by the sale and purchase of sterling exchange at fixed rates.

The detailed history of the Indian currency exper-

iment would fill a book. Sufficient to say here that in the main it has been successful. It is true that in the first twenty years of its existence there were several adjustments of the exchange rates at which the government sold its bills but these were usually for fractional amounts of a penny.

It will be remembered that up to 1914 the course of silver prices was downward and the price of silver was not a markedly disturbing factor in the monetary difficulties. But shortly after the outbreak of the Great War silver advanced rapidly in price in the New York market and still more in the London market. The ratio of one pound sterling to 15 rupees departed widely from the commercial ratio. Adjustment to this condition could of course have been made by reducing the silver content of the rupee but this would have been a difficult and dangerous expedient and physically impossible at the time. It was obviously simpler to change the ratio by giving gold a lower value in rupees. During the rise in the price of silver several changes of this nature were made and in February 1920 the ratio of 10 rupees to the sovereign was established. This measure did not, however, fulfill the expectations of its advocates largely for the reason that it established an equivalence with the theoretical gold standard of Great Britain, and not with the paper standard actually existing. We have in fact two variables, the gold price of silver and the gold value of sterling, and the effort to estab-

lish a fixed relation between them has as might be expected met with only indifferent success.

Those who have followed what has been said in this volume on the price of silver will not be surprised that this measure proved abortive. Only for a few months could exchange be held somewhere near the 2 shilling ratio. With the subsequent fall in the price of silver, combined with an unfavorable condition of Indian trade, it soon fell to approximately 1s.4d. to the rupee. The situation which prevailed after 1920 was also greatly complicated by the existence of a large mass of paper currency. The rehabilitation of this paper, its adjustment to the silver circulation, and that of the latter to gold both in domestic and foreign relations, were much discussed and by gradual evolution an approximate return to pre-war conditions is being realized.

11. *Philippine currency and exchange.*—When the United States acquired the Philippine Islands it found in circulation a mongrel silver currency composed primarily of the Spanish-Filipino peso and the Mexican silver dollar which circulated concurrently in local trade, tho there was a slight difference in their silver content. In the first days of military occupation there was need of some working basis for the exchange of American money into the local currencies. This was satisfied by accepting two Mexican or Spanish-Filipino silver dollars as one Amer-

ican dollar. This temporary arrangement worked fairly well but thru variations in the price of silver was not altogether painless. It brought confusion into the government accounts and transactions and emphasized the needs of a permanent adjustment.

This involved two things, the establishment of a uniform internal currency and keeping the currency so established in a uniform relation to the American standard of value.

12. *Coinage system.*—The Act of Congress of March 2, 1903, "To establish a standard of value and to provide for a coinage system in the Philippine Islands," recognized that the Mexican dollar of 417.7 gr. (900 fine) was an interloper in the Philippine Islands and that the Spanish-Filipino peso did not have a fixed par with gold. The new silver peso was to have .416 gr. (900 fine), and thus a weight was adopted which would it was hoped favor the expulsion of the Mexican dollar. The act also established as the unit of value the gold peso weighing 12.9 grains (900 fine) which was to become effective after the silver pesos had reached a certain specified circulation.

13. *Issuance of certificates.*—The second phase of the Act which concerns us here was a provision authorizing the issue of certificates for the purpose of carrying out the Act. In October, 1903 this law was supplemented by an Act of the Philippine Commission, "Constituting a gold standard fund in the Insular Treasury, to be used for the purpose of maintain-

ing the parity of the silver Philippine peso with the gold standard peso, etc." The essential feature of the Act was that which empowered the Insular Treasury to sell drafts against this gold fund in the United States and to authorize its depositaries in the United States to sell drafts against the fund in the Philippine Islands to be paid in local silver currency.

14. *Philippine Act of 1906*.—For a few years things went well, but as we have already noted silver advanced in price in the early part of the century and the margin between the bullion value of the peso and its coining value disappeared in 1905. According to silver prices current in 1905 and 1906 the bullion value of the peso was greater than its face value. It was feared that large quantities of it would go into the melting pot and be exported to China. A rigid law forbidding melting or export of the coins was immediately passed as a temporary expedient.

A readjustment was necessary. The condition had been foreseen; outline of a plan had been prepared and new forms of coin tested. This work was completed on cable instructions from Washington by an Act of the Philippine government of December 6, 1906. This act reduced the weight of the peso to 20 grams (308.66 grains) and its fineness to .800, the effect being to change its ratio to gold which had been 32.25 to 1 to 21.3 to 1. With this change the melting point would not be reached until standard silver in London reached a price of $44\frac{3}{8}$ pence. When the act was passed the London price was

31½ d. The same law made the subsidiary coins the exact subdivisions in weight of the peso, but gave them a fineness of .750, equivalent to a London price or 47½ d per standard ounce.

15. *Results of currency adjustment.*—The adjustment of the currency effected in 1906 to 1909 seems to have worked out well until the Great War, both as a currency and an exchange measure. The lowered silver content of the peso seemed to offer ample protection against currency disorders thru any probable change in the market price of silver, the subsidiary coinage thru its lesser fineness being still further protected. Following the example of the United States, silver certificates were introduced and formed a large part of the actual circulation. The silver pesos on deposit for the security of these issues were kept as a separate certificate reserve. In one sense this fund differed from the holdings of the United States Treasury. The deposits were made in silver but could be held in gold, if desired, and the certificates issued against them were made redeemable in pesos or in United States gold coin at the option of the Philippine Treasury. The certificates were not, therefore, in the same sense as in the United States mere warehouse receipts, and the language of the law and custom gave to the bullion on deposit somewhat more the character of a banking reserve. At a later period, after the funds and the management of the system had been put into the charge of the Philippine National Bank, this deposit was merged with the

gold exchange fund, and became a part of the "Currency Reserve Fund." It then appears to have become substantially a banking reserve and not to have been kept up to the full amount of the obligations outstanding against it. The fusion of two reserves makes it difficult to determine this point with precision.

16. *Rise in silver affects peso.*—After the outbreak of the war, as we have seen in the Chapter on the silver standard, there came a rise in the price of silver which exceeded all previous advances and threatened the integrity of the currency. In the year 1917 the Treasurer of the Islands reports that at the sterling price of silver and the cross rate of exchange on New York, the bullion value of the peso rose to 1.22. This naturally precipitated a demand for the coins for export and other bullion purposes. Fortunately for the treasury the greater part of the currency was in the form of certificates. The treasury took every possible means to evade the conversion of the certificates into silver coin and was able to stave off for the time being the raid on the currency. With the subsidiary coins it was not equally fortunate. Considerable quantities of them disappeared from circulation and a dearth of small change made itself felt. This was met in part by authorizing the National Bank to issue notes of a smaller denomination than one peso, which filled the same function as the "fractional currency" issued in the United States during the war between the States.

17. *Currency reserve fund passes to Philippine National Bank.*—In the meantime the currency reserve fund had passed into the hands of the Philippine National Bank. It appears to have regarded it in some measure not as a fund pledged to a definite purpose but as a part of its assets subject to loans. Silver remained above the bullion value of the peso during 1919 and 1920 but the prosperity of the Island and the activity of business led to only small demands for the redemption of the Treasury Certificates. With the subsequent depression the Bank found itself unable to meet the demands made upon it.

18. *Report on Philippine conditions.*—General Wood and Mr. Cameron Forbes in their special report to the President on Philippine conditions in 1921 said:

The currency resources have been depleted, the silver on deposit to redeem the currency has been pledged and used for other purposes. The fund for the maintenance of the parity of gold and silver is involved in this loss, with the result that instead of metallic and cash basis for the currency, its principal support is the pledge of the Philippine government and the confidence that the United States will not permit these things to happen again. The currency is now practically a fiat currency.

19. *Exchange aspects of Philippine experience.*—Let us turn now to the exchange aspects of the Philippine experience. The gold exchange fund provided by the first law amounted to over 40 per cent of the outstanding government circulation, a

proportion later reduced to 35 per cent. The greater part of it was deposited in New York and the smaller part of it in the Manila banks. The government sold exchange on New York against its deposit there at a small premium calculated to be approximately the cost of making a gold shipment. In like manner, tho to a much smaller extent, it sold in New York drafts payable in Manila pesos. The system worked to the entire satisfaction of the commercial community and the incidental profits made it possible for the government to pay all the expenses of the operation and increase the gold reserve fund.

With the creation in 1916 of the Philippine National Bank this function of selling exchange passed into the hands of the bank. Even before this date there had begun a series of measures of doubtful expediency which led such an intelligent observer of monetary conditions as Professor E. W. Kemmerer, who had been the active administrator of the systems during its first three years, to foresee disaster. Subsequent events have amply justified the anticipations expressed in his work on "Modern Currency Reforms" (1916).

The first assault upon the integrity of the gold exchange fund was a provision that to the extent of 50 per cent it might be loaned to municipalities on ten year contracts. It is obvious that such a proceeding cut the fund practically in half. On an estimate of the fluctuating demand for currency in

the Islands, Professor Kemmerer in 1916 expressed the belief that while a 35 per cent reserve might be in excess of needs, such a reserve could not with safety be less than 25 per cent. It is not to be wondered then that he was concerned over a measure which reduced the effective reserve to $17\frac{1}{2}$ per cent of the outstanding currency. A later measure permitted the use of four-fifths of the legal gold standard fund for long-time loans and thus reduced the liquid reserve to only 7 per cent of the outstanding currency.

After the establishment of the Philippine National Bank and under the policy described in the preceding paragraph the funds formerly on deposit in New York were for the most part transferred to the Philippine Islands. The anchor that held the Philippine currency to the gold standard was lightened and the cable weakened. It has already been noted that the Treasury certificate fund was merged with the gold standard fund. The joint currency reserve fund was given into the custody of the Bank. The latter lacked real financial leadership and the evidence seems to be that this fund became merged with the general assets of the bank. The results of dubious legislation and inept management are summed up by General Wood and Mr. Forbes in these words:

“One of the functions of the National Bank was to manage government exchange. Having transferred all the funds usually available for exchange

to Manila and then having loaned the money in such a way that it could not be recovered, the government had to discontinue selling exchange. The rates ran up as high as 15 per cent."

Thus in part under the influence of unforeseen world events, in part because of mistaken legislation and inexperienced management the structure of Philippine currency and exchange so carefully constructed went to pieces.

20. *Reconstruction of currency system.*—With the return of General Leonard Wood to the Islands as Governor General the reconstruction of the system was begun. The first step in 1922 was the definite separation of the Treasury certificate fund from the gold standard fund, and the issue of bonds in the United States to replenish them and place them on a sure foundation. In his message to the legislature in October, 1922 General Wood insisted that the unfortunate experience of recent years had taught the lesson that these funds should be both adequate and liquid. It is much to be hoped that the lesson has been learned as well as taught.

21. *Possibilities of the gold exchange standard.*—Thus far the gold exchange standard has been used primarily as a means of stabilizing the silver currency of a dependency by establishing a fixed exchange ratio with the gold standard of the mother country. It is perhaps not essential to the existence of such a standard that the currency of the dependency should be based on silver. It might in theory at least be

equally well a paper currency, tho such a case has not yet arisen, unless it be in the case of Austria at present.

Nor is it on the other hand essential to the nature of a gold exchange standard that the area in which it is applied be a dependency. It is quite conceivable for example that an independent Central or South American state should enter into such a relation with the United States or that Persia, Egypt or Arabia might enter into a similar accord with Great Britain. In fact, Egypt practically did so during the War.

However the political consequences which would follow such a course are not to be ignored. In some degree the independent country would give up its independence and frankly and openly place itself if not under the control of the greater power, at least distinctly within the latter's "sphere of influence." It is probable that in many instances this would be deemed too high a price to pay for the advantage of stable currency and stable exchange.

REVIEW

Define the gold exchange standard and explain its relations to the gold standard on the one hand and the silver standard on the other.

What were the main motives leading to the adoption by silver using countries of a gold exchange standard?

Describe the mechanism of the gold exchange standard, the usual processes of valuing silver and keeping its gold exchange relatively fixed.

Relate the experience of Indian currency.

Show how the principles of the gold exchange standard were established in the Philippines and subsequently violated.

CHAPTER XV

PAPER MONETARY STANDARDS

1. *Prevalence of paper money standards.*—The preliminary chapter made it clear that in present day trade the gold standard is no longer that most widely current. The study of foreign exchange relations becomes to a large extent a discussion of exchange conditions in paper standard countries, both in their relations with countries that still use gold and among themselves. It will be seen that the essential principles of international exchange are not changed by this situation, tho their statement requires considerable modification. Before discussing, however, the international effects of paper currency it will be desirable to familiarize ourselves with some of the results of paper standards in domestic affairs.

2. *Origin of paper standards.*—A country is said to be on a paper basis when its currency has no present convertibility into metallic money. Such a situation commonly arises thru the exigencies of war financing. In theory practically every nation has a gold standard, the law defining the monetary unit as a fixed quantity of gold, but practice often departs widely from theory. Paper standards result when specie payments are suspended by the government or

by the banks issuing currency under government authority, under conditions which bring into circulation an amount of currency that at par would be in excess of the needs of trade and commerce.

The usual condition which leads to the abandonment of metallic payments and the issue of irredeemable paper currency is the need of governments for means of payment to meet the extraordinary expenditures forced upon them by military operations. From the standpoint of monetary theory it is immaterial whether the issues in question are made directly by the government, or whether they are made by banks and loaned to the government for its use. Both methods of forcing this irredeemable currency into use have been followed, frequently simultaneously. It is a notorious fact that the ease with which such issues are made in the first place tempts governments to repeat them, and this facility may plunge them into national bankruptcy and complete or partial repudiation of their obligations. The historic instances of the Continental currency of the American Revolution and the "Assignats" of the French Revolution have been paralleled in our own day and generation by the collapse successively of the Russian ruble, the Austrian crown and the German mark.

Historians and economists have delighted to recount the story of these disasters, and in doing so they have perhaps unwittingly given color to the belief that the paper money disease once contracted must always terminate fatally. Happily this is not the

case; the patient may suffer acute pain and be subject to the annoyance of a long and wearisome convalescence but in many instances he has ultimately recovered.

Between the wild vagaries of a paper money situation such as prevailed in the year of 1923 in Germany and an ordered state of affairs like that found in Great Britain, where currency was at a slight discount only as compared with gold, there is the possibility of an infinite number of gradations. This should render us cautious in regard to positive pronouncements as to the effects of a paper money regime. In some cases it may represent only minor inconvenience in business affairs, while in others it portends the complete collapse of the economic and financial structure. The evils of a paper currency are only in part evils of kind; for the greater part they are evils of degree.

With this understanding we may now examine some of the effects which experience has shown to be connected with paper issues.

3. *Depreciation.*—The mention of paper money is almost instinctively associated with the idea of a greater or less degree of depreciation of the currency. Despite this association of ideas, depreciation is not in theory at least the necessary consequence of an issue of paper money.

Depreciation follows when there is an excess of the quantity of money in relation to the volume of business which is to be effected by it. If a country on a

gold basis were to issue an irredeemable paper currency the probabilities are that in the first instance prices would rise, partly because the money volume had increased, partly because the economic demand for money had diminished as a result of a questionable fiscal policy. Yet if the ultimate effect of the issue were as it probably would be, to drive gold out of circulation, the aggregate money in circulation might not increase provided the new paper money went no further than just to replace the gold. It is possible that during the process of replacement the volume of money might for a time be lower than before. In the long run, unless other circumstances arose to affect the demand for money, prices would return to their normal level. A moderate issue of paper money would not necessarily result in increased prices and its equivalent depreciation of currency. Experience, however, has shown us that moderation in the issue of paper money has been a virtue rarely exercised.

Turning now to the more usual case in which depreciation follows the issue of paper currency we find that this depreciation reveals itself in two ways; first, by a premium on gold and, second, by a rise in prices in excess of that noted in gold standard countries. When the gold market remains open the measure of depreciation in comparison with gold is easily and accurately ascertainable. On the other hand governmental measures to control the gold supply may be so effective as to remove it entirely from the market

and in this case the direct gold test becomes impracticable. An indirect gold test, however, is supplied by the rates of exchange on gold using countries; in other words, if domestic gold is not purchasable, resort may be had to the price of foreign gold exchange. To consider this phase of the question at this point would anticipate the discussion of later chapters and it must be passed over here with a mere notice.

The second test, that of a rise in the price level is unmistakable. Prices and currency values are reciprocal. A general rise in prices which decreases the quantity of goods which a given unit of currency can purchase is the same thing as the depreciation of that currency. In the same way a general fall in prices when it occurs is the equivalent of increased purchasing power, or an appreciation of the money in which goods are valued.

4. *Price changes.*—Whether in gold using countries or in paper standard countries, prices at the present time are higher than they were before the War. The following figures showing relative prices for 1919 to 1927, compared with 1913 prices as a basis for some of the leading nations are evidence in point.

Price Indexes, 1913 = 100

	1919	1920	1921	1922	1923	1924	1925	1926	1927
United States (1)	203	204	123	131	145	139	141	140	139
Canada (2)	215	246	181	165	166	165	160	115	...
Great Britain (3)	242	295	182	154	152	165	139	148	...
France (4)	358	512	347	328	419	489	550	690	...
Italy (5)	381	650	601	586	598	609	690	708	...

(1) Bradstreets (2) Dept. of Labor (3) The Statist (4) Stat. Gen. de la France (5) 1914 = 100, Dept. of Commerce.

The figures are compiled by the index number method. This method, it is to be understood, indicates tendencies and measures approximately, but not with mathematical accuracy, price variations. The testimony of the figures is conclusive to the effect that the largest increases of prices are found where paper money has been most lavishly issued.

5. *Instability*.—Because of the ease with which paper money is issued and because governments have been led to adopt in their finance what seemed to be the easiest way the stigma of instability has been attached to paper money. However, it is to be remembered that in mechanical or engineering science stability means one thing and in economic affairs, another. In the field of economics stability is at the best a relative matter.

We are accustomed to think of gold money as stable. It is in fact stable only in weight, not in value. Its value is expressed in its command over commodities, and since that command decreases and increases, in other words since the general level of prices rises and falls we cannot speak of gold as having a stable value. On the other hand its changes are comparatively slow and gradual—it is relatively stable. This is the case because as a rule the quantity of gold available for currency purposes can only change in this way. It is in the main increasing, but, that increase may lag behind the effective demand for it, or it may outstrip it. When the demand for gold for monetary uses is spread over all the nations of the

earth price changes among the nations so linked together in their monetary interests will not occur rapidly. When circumstances tend to increase rapidly the monetary gold of a given nation, as in the United States since 1914, price changes will be more rapid and greater.

The instability of paper money in like manner arises from the fluctuations in its amount. Except in the case of such disordered finances as have been observed in eastern and central Europe these fluctuations are not likely to be either sudden or violent. Diminution of the paper money supply is ordinarily a slow process; its increase is however more rapid than similar changes in gold using countries. Not infrequently does it happen that it filters into circulation so deliberately and prices rise by such small gradations that the public is unaware of the causes of the change.

When the amount of the paper money in circulation is relatively stable, the value of the monetary unit, as revealed in gold prices, gold exchange and general prices, will be relatively stable also. This is the characteristic of periods of recovery from the excesses of paper money. It is chiefly during the periods of issue that the defects and inconveniences of paper money reveal themselves. During this period the needs of the government often lead it to increase the amount of its issues rapidly, even with startling rapidity, as in Germany in 1923, while prices rise correspondingly and the value of the currency falls.

These changes are dictated by considerations quite different from those which affect the stability of money in gold standard countries.

6. *Isolated systems*.—From the standpoint of international exchange to which we shall shortly recur the important thing to be remembered is that the emergence of the paper standard breaks down the links that bind it to the monetary systems of other nations. When the nations used gold as the basis of currency there was in effect an international currency. When gold is banished from circulation each nation has its own independent standard. It will of course retain the old names for its monetary units, but they become comparatively meaningless in international relations. The mint pars which were the standard equivalences between different currencies are laid on the shelf, when pound sterling and franc and lira no longer represent each a fixed quantity of gold. In a certain sense therefore it is scarcely correct to speak of a paper standard when there may be dozens of them. However, since they have many common characteristics little confusion is likely to result from following the accepted usage of words.

7. *Paper money and the money functions*.—The Modern Business Text on "Economics" describes the principal functions of money as a medium of exchange, a measure of value, and a standard of deferred payments. Such paper money as we have been considering serves the first purpose, when the people have become accustomed to it, quite as well as

metallic money. If we omit the time element altogether it serves equally well as a measure of value, enabling one to measure the worth of one commodity against that of another. But as soon as the time element is introduced and money is considered as a standard of deferred payments paper money has serious drawbacks. On the one hand the well grounded fear that the monetary unit will fall in value makes men chary of undertaking future commitments, especially those which cover a long period of time. Again depreciation of the money unit lessens the burdens of past obligations. Creditors suffer thru the depreciation of the currency. Savings and investments and corresponding income shrink and real distress may ensue.

8. *Monetary chaos*.—All of the phenomena of paper money thus far discussed appear in grossly exaggerated form when the printing presses pour out continuously new issues in such vast quantities that the designation "money" becomes a joke. When for example it was reported by the Russian Department of National Economy that prices in August 1922 were 5,026,074 times greater than in 1913, the foreigner could not adjust such a condition to his mental processes. When, in October, 1923, we read that it required 55 billion German marks to purchase one dollar the figures were staggering. One wonders indeed how with such a revolutionary displacement of values the economic life of the country can go on at all. But men must eat and the needs of existence

are as imperious as ever. In one fashion or another men adjust themselves to circumstances far removed from their usual mode of life.

So called "money" practically loses all its value, prices vary from day to day by astonishing amounts. The history of former currency disaster repeats itself. Men resort largely to a system of barter or openly or surreptitiously make their trades in foreign money. The foreign money may actually pass from hand to hand, or it may be a mere accounting device—what the economists sometimes describe as a money of account—actual transactions being liquidated in the money of the country.

Such a money issue as has been made in countries of eastern and central Europe amounts in effect to a redistribution of the national wealth. Old debts, representing in large part the accumulations of the past, are practically wiped out. Insurance policies, for example, amounting in value at the time of issue to \$1000 have been paid off in Austria by the payment of the stipulated number of Austrian crowns worth only \$10 at the time of payment. Instances of the iniquity of such a situation could be multiplied, but it is not our purpose here to point a picture of the economic disintegration which follows the unbridled issue of paper money but merely to show how it creates a situation in which all familiar economic standards disappear.

9. *Paper standards essentially temporary.*—Altho on occasions economists have defended and political

parties have advocated the paper standard of money as the ideal one, no nation has as yet accepted the paper standard except in a spirit of resignation. The dream of every country with disordered monetary standards is to link up again their currency with the gold basis and establish fixed parities with other nations.

The practical methods by which such a dream might be realized are in essence two, restoration and stabilization.

10. *Restoration*.—The problem of restoring the gold standard is that of bringing back the paper money to an equivalence with the monetary standard fixed by law before specie payments were restricted or suspended. This is what occurred in Great Britain after the Napoleonic Wars and in the United States after the War between the States.

The problem which confronts a nation desiring to accomplish this result is to bring its gold holdings and paper issues into such a relation that the redemption of the latter in the former can be safely undertaken. To do this gold holdings must be increased or currency issues diminished or both. There is often a strong popular opposition to the latter course. A deliberate reversal of an economic or monetary policy is always difficult, tho it can oftentimes be abandoned. False steps in monetary policy have rarely been retraced, but nations have halted in their tracks, and with the passage of time, elements dangerous to the monetary integrity of the nation have become innoc-

uous. Or to put it in other words, the contraction of the paper money necessary to its ultimate redemption in coin has been relative rather than positive.

Given the difficulty already noted of reducing the amount of paper currency in circulation, the process of bringing it back to convertibility is likely to be a slow one. During this process the monetary situation gradually improves and the inconveniences of a paper standard gradually lessen.

Whether or not a nation can return to the gold basis thru the restoration route obviously depends upon two things, first the extent to which its currency has departed from its gold basis and second the length of time which it is willing to devote to the process. After the World War, Great Britain and Canada closely approached their former gold standard and by the end of 1925 they had already restored their respective currencies upon the former basis. Whether any of the other nations are in a position to travel this route may be questioned. There are in France a few ardent advocates of such a course—the only one, they claim, which is compatible with national honor—but for the most part public opinion in France as in other parts of Europe seems to be merely drifting.

11. *Stabilization.*—The second course open to nations that find themselves on a paper monetary basis is stabilization thru devaluation. This means in effect a frank recognition of the fact that the actual standard of value has departed from the legal standard, and a proposition to bring them together by

lowering the legal standard to conform to the actual standard, or to set up a new standard which it is practicable to reach and maintain.

To make this clear let us resort to the time-worn expedient of the novelist and conceive ourselves in an imaginary country. Its standard of value solemnly proclaimed by law is the gold "mical" consisting of 2 grammes of fine gold. The older generation remembers the handsome gold coins of five and ten micals, but the younger numbers of the community know only their paper namesakes. In the course of time the latter have come to have a value just one half as great as the gold mical of law and tradition, and have stood at this point with minor variations for a number of years. The country's finances being in a sound condition, the demand arises for a return to the gold currency. The government "stabilizes" the currency by means of a decree that the monetary unit shall henceforth be a gold mical of one gramme of fine gold and that all paper currency shall be redeemable in gold of the new issue at the national bank.

Assuming that such a policy were carried out what would be its effects? Current obligations of merchants and others would not be changed in the slightest. Most of them were created on the paper basis, bearing in fact, tho not in name, the same relation to gold as that now established by law. Older debts contracted before the depreciation of the mical would be scaled. In many cases such debts had been transferred since they were originally contracted, and the

loss thru the depreciation of the currency had already been suffered. Debts due to foreigners, as far as they had been contracted in foreign currencies or in "gold micals of the weight and fineness established by law," would not be affected by the change. Opponents of the measure would undoubtedly raise the cry of repudiation and a certain abstract justice in such a contention is not to be denied. Assuming that the depreciation of the mical has been long continued, there is no doubt that many suffered, from time to time, loss thru the fall of its value. To restore its value to the former standard, while reestablishing the monetary system of the country, would not however, compensate these losses to the persons who had suffered them. As compared with restoration, stabilization eliminates the prospect of gain thru an appreciation of the currency in returning to its former value.

It is to be understood that in presenting this situation there is no intention of any application of this analogy to any specific nation. Because each has its own special problems it has seemed wiser to confine the explanation of the underlying nature of the stabilization problem to general terms.

12. *International relations.*—The domestic aspects of paper money must necessarily form the background of any discussion of its international aspects, namely its relations to other standards thru international exchange. Of these relations the following chapters will treat. It is sufficient to have pointed

out here that paper money is not as many seem disposed to think, a mere caricature of a monetary system, but that it may do the internal work of money in a very serviceable and satisfactory fashion. It may not do the external work of money with equal satisfaction, but the effects on international relations are by no means so far reaching as is commonly supposed.

REVIEW

Describe the usual origin of paper currency standards.

Explain why a paper standard usually depreciates in value, and how that depreciation can be measured.

Discuss the causes of instability in value of paper standard money and whether it is a necessary consequence of such issues.

Show how paper money serves each of the various functions commonly ascribed to money.

Explain two methods by which a country using irredeemable paper money can attain the gold basis for its currency, and the relative advantages of each method.

CHAPTER XVI

PAPER STANDARD EXCHANGES—WITH GOLD-USING COUNTRIES

1. *The problem of paper exchanges.*—The absence of fixed standards of comparisons for the exchange of the currency of one country into that of another invests the paper standard exchanges with an air of mystery which is apparently impenetrable. The reader, however, who has grasped the principles underlying silver exchange standards and methods should find no great difficulty with the subject. He will see that the problem which presents itself is a two-fold one, involving

(a) Exchange relations between paper standard countries and those having the gold standard.

(b) Exchange relations between one country on a paper standard, and another country having also a paper standard.

It is to the first of these two phases of the subject that the present chapter is devoted.

2. *How trade is conducted.*—The fundamental fact of foreign commerce is that one nation has something to dispose of which another wants and that these wants are reciprocal. Wherever this situation exists some means of trading will be found. Civilized nations have never been at a loss to secure the goods

they wanted from savage tribes. Payment is sometimes made in precious metals but more often it is made "in kind." The native commodity is exchanged for the foreign commodity.

The apparatus of foreign commerce among civilized nations with all its banking and exchange institutions is far more complicated than in such primitive conditions but the operation is essentially the same. We can not truly understand the mechanism of commercial relations between the nations unless we realize clearly the truth of these two statements:

First, all foreign trade is essentially of the nature of barter, a nation's exports of goods necessarily being in the long run equal in value to its imports.

Second, the so-called balance of trade, which may be settled by a shipment of gold when the trade is between gold standard countries, is not a real balance and may be wiped out by the shipment of commodities other than gold or by evidences of indebtedness.

Let us assume a very simple example in which one man both exports and imports. The United States has wheat to sell, and France has silk to sell. Let our merchant export wheat valued in our market at \$50,000. Whether the franc is worth at the time 19 cents or 10 cents is a matter of indifference to him provided he can buy silk advantageously with the francs received in payment. Disregarding for the moment all questions of costs, interest and profits, it is evident that, if the francs received will purchase a quantity of silk which when imported will sell for

\$50,000, we have the basis of a trading proposition. The introduction of the elements of costs, interest and profits does not essentially change the situation. Neither would it be affected by the consideration that exporter and importer were different persons. In the latter case the exporter receives in exchange for his wheat the right to receive payment in France, in effect he transfers this right to the importer who uses it to buy silks.

At any given time it is of no consequence for the purposes of commerce whether the franc is rated high or low. What concerns the trader is the fact that he acquires thru his operations, or uses in them, a certain purchasing power of foreign currency. If the latter is high it will contain fewer units of the foreign currency than if it is low. Where the export of commodities is matched as here against their import, the condition of a satisfactory trading is only that the valuation of the foreign unit remain fairly constant during the operation. It is in such a case merely a mode of reckoning.

3. *Adjustment of the trade balance.*—But what of the case where trade does not have this exact balance, where as a result of trading operations the paper standard country remains indebted to the gold standard country? How shall this indebtedness be liquidated? Before the questions are answered it may be worth while to note that they are less important than they seem to be. Between countries on a gold standard, shipments of the precious metal are compara-

tively rare. The mechanism of trade, the movement of prices and the operations of the exchange market tend to reduce such adjustments to a minimum.

Where shipments of metal are not available as a means of adjustment, the currents of trade and the movements of prices operate still more effectively to make them unnecessary. As we have seen, the international movement of payments concerns investments and services as well as goods, and apparent discrepancies are often accounted for thru these "invisible" items. In the case in point it is conceivable that the debt might be liquidated in part by the sale of securities of the debtor country to the creditor country.

What is more likely to happen, however, is a readjustment of relative price levels stimulating the exports of the debtor country and slowing up those of the creditor country until an adjustment had been secured and this floating debt extinguished.

4. *Exchange rates.*—When paper currency is no longer connected by convertibility with the gold units which it represents, exchange quotations reflect in the main the relation of the currency to its former standard. Changes in the rates may reflect changes in the status of the currency or may indicate the trend of commercial relations. The following statement from the New York *Times* is typical of exchange quotations in recent years.

In the subjoined table the quotation on sterling represents dollars and decimals of a dollar; all others represent cents

and decimals of a cent. Quotations preceded by the decimal mark indicate a price measured in fractions of a cent.

FRIDAY, FEBRUARY 6, 19—.

Range of Rates, Sight Exchange.

	High	Low	Final	Thursday's Final
London	\$4.78 $\frac{1}{4}$	\$4.77 $\frac{7}{16}$	\$4.77 $\frac{1}{2}$	\$4.78 $\frac{7}{16}$
Paris	3.91 $\frac{13}{16}$	3.91 $\frac{1}{4}$	3.91	3.92
Rome	4.14 $\frac{3}{4}$	4.14 $\frac{1}{4}$	4.14 $\frac{1}{2}$	4.15 $\frac{1}{2}$
Amsterdam	40.26	40.21	40.22	40.26
Berlin	23.81	23.80	23.80	23.80
Madrid	14.29	14.27	14.27	14.29
Stockholm	26.94	27.93	26.93	26.94

Closing Rates.

Party of exchange is given as reported by the United States Mint, except in countries with a silver standard, where parity fluctuates with the price of silver.

Europe.

	Fri- day	Thurs- day	Week Ago	Year Ago
Sterling—Par \$4.86 $\frac{5}{8}$ per sovereign				
Demand	\$4.77 $\frac{1}{2}$	\$4.78 $\frac{7}{16}$	\$4.79 $\frac{1}{4}$	\$4.29 $\frac{5}{8}$
Cables	4.77 $\frac{3}{4}$	4.78 $\frac{11}{16}$	4.79 $\frac{1}{2}$	4.29 $\frac{7}{8}$
Com., 60 days . .	4.73 $\frac{7}{8}$	4.74 $\frac{7}{8}$	4.75 $\frac{5}{8}$	4.26 $\frac{3}{4}$
Com., 90 days . .	4.72 $\frac{3}{8}$	4.73 $\frac{3}{8}$	4.74 $\frac{1}{8}$	4.25 $\frac{1}{2}$
FRANCE—Resolved at 3.91 $\frac{3}{4}$ cents per franc				
Demand	3.90 $\frac{5}{16}$	3.90 $\frac{1}{4}$	3.90 $\frac{5}{16}$	3.91 $\frac{13}{16}$
Cables	3.90 $\frac{5}{16}$	3.90 $\frac{1}{2}$	3.90 $\frac{9}{16}$	3.92 $\frac{9}{16}$
ITALY—Par 19.3 cents per lira				
Demand	4.14 $\frac{1}{2}$	4.15 $\frac{1}{2}$	4.16 $\frac{1}{4}$	4.38
Cables	4.15	4.16	4.16 $\frac{3}{4}$	4.38 $\frac{1}{2}$
BELGIUM—Par 19.3 cents per franc				
Demand	5.13	5.15 $\frac{1}{4}$	5.18	4.03 $\frac{1}{2}$
Cables	5.13 $\frac{1}{2}$	5.15 $\frac{3}{4}$	5.18 $\frac{1}{2}$	4.04

GERMANY—Par 23.8 cents per mark

Demand	.....	23.80	23.80	23.80	.....
Cables	.....	23.80	23.80	23.80	.....

AUSTRIA—Par 20.3 per crown

Demand	.....	.0014 $\frac{1}{8}$	.0014 $\frac{1}{8}$	.0014 $\frac{1}{8}$	.0014 $\frac{1}{16}$
Cables	.....	.0014 $\frac{1}{8}$	.0014 $\frac{1}{8}$	.0014 $\frac{1}{8}$	.0014 $\frac{1}{16}$

CZECHOSLOVAKIA—Par 20.3 cents per crown

Demand	.....	2.95 $\frac{1}{2}$	2.95 $\frac{3}{4}$	2.97 $\frac{3}{4}$	2.91 $\frac{1}{4}$
Cables	.....	2.95 $\frac{1}{2}$	2.95 $\frac{3}{4}$	2.97 $\frac{3}{4}$	2.91 $\frac{1}{4}$

These quotations, in the discrepancies observed between the “mint par” and the actual value in New York of the different monetary units, indicate approximately how far the different currencies have deteriorated. In February, 1923, the old German mark was practically valueless, and 1924 quotations refer to the new mark. The figures given show comparative stability, with notable improvement in sterling exchange.

It must be obvious that the mint pars here cited have no bearing upon commercial relations. Under normal exchange, it is true that low exchange stimulates temporarily imports from the countries against which exchange is low. But this rests upon the assumption that the foreign unit retains its full purchasing power. When this situation exists the divergence between the mint par and the exchange measures approximately the degree of stimulus to exports or imports as the case may be.

Under abnormal exchange there may be a stimulus to exports or to imports arising out of the fact that the paper currency of a country may have a greater or a less purchasing power in foreign markets than in domestic trade. But this fact is not revealed by the divergence of the exchange rate from the mint par, which under such conditions has a purely nominal or perhaps it would be better to say historical interest.

5. *Exchange parities.*—The reader may have noted that the quotation given speaks of the mint pars as the “parity of exchange.” He will recognize that under actual conditions this is at best only a theoretical and not an actual parity. The gold franc is no longer the standard of value in France, for example, but rather something far less definite which goes under the name of the franc. What is the actual value of the franc? If it could be ascertained, we could calculate the actual par of exchange between France and the United States and with such a par we could determine whether the cable rate for February 6 of $5.38\frac{1}{4}$ cents represented favorable or unfavorable exchange.

International exchange is only thoroly understood by a reference to the value of one currency in terms of another. In the case of two countries with a common metallic standard this can be precisely calculated. When different standards prevail the computation can never be so exact, but at any given time there is a temporary ratio of currency values,

which may on the one hand correspond to, and on the other hand may differ from, the exchange ratios.

6. *Gold exchanges translated into currency.*—In the explanation of silver exchange the gold price of silver appeared as the link between the gold standard and the silver standard. In analogous manner the exchange relation between a gold country and a paper standard country can be explained by reference to the currency price of gold provided the latter figure can be obtained.

During the suspension of specie payments in the United States gold disappeared from every day circulation but not entirely from monetary use. The interest upon the public debt was payable in gold and so also were customs duties. There was therefore, apart from any questions of foreign exchange, a steady demand for gold and an open market for it. It had a definite quotation on the stock exchange in the same manner as stocks and bonds. With the price of gold thus precisely known it would have been a comparatively easy matter at any given time to compute the normal value of the pound sterling in American currency and compare this with the rate of exchange.

Such a procedure, however, was not called for by the commercial practice of the time. Exchange quotations were made not in currency but in gold. It was the habit of that generation to quote in New York the price in cents of 54d. sterling, equivalent to a mint of \$1.09 $\frac{1}{2}$ cents. It was about this figure

that the quotations for sterling exchange grouped themselves. To find the equivalent in currency, the rate which for example, one would have had to pay at the bank for a sterling draft, the exchange quotation had to be multiplied by the gold quotation for the day.

7. *Currency exchange translated into gold.*—A somewhat different situation exists in Great Britain today. Restrictions upon the sale of gold were removed in part in September, 1919 and since then the market has been more and more freed from war-time restrictions. London financial papers have quoted for some time the price of gold, daily quotations being available since the middle of 1920. So much for the similarity of the two situations. The dissimilarity consists in the fact that London quotes exchanges in currency. For example on June 23, 1926 gold sold in London at 84s., 11d. per fine ounce, and cables on New York were quoted at 4.8665. The gold quotations meant that an ounce of fine gold which had a coinage value of 77s., 10d., sold at a premium of 7s., 1d., equivalent to 9.10 per cent. Conversely currency was at discount of 8.34 per cent as compared with gold in London. The exchange quotation meant that one pound sterling, which when coined in gold had a value in American money of \$4.8665, was in its paper representative capable of purchasing \$4.8665 of American money, or was selling at par.

There is not the correspondence here which we

should expect. In a certain sense London exchange on New York can be considered as the London price of American gold. In the instance given the currency price in London of London gold is considerably higher than the currency price of American gold. The divergence between the two prices can only be explained by the restrictions upon the gold market in London which tend to give gold a scarcity price. If, then, gold is uniformly rated higher in the London market than in the New York market the special circumstances under which it is bought and sold make it an inadequate test of the depreciation of the currency and render it useless for the computation of an approximate exchange parity.

8. *Gold prices and exchange rates.*—This does not mean that gold prices and exchange rates are unrelated. If they have not the approximate identity which would be expected in a wholly free market, they are none the less subject to the same movement. Any increase in the price of gold in London is coincident with a downward movement of the London cable quotation in New York; any decrease in the gold price in London is matched by an increase of the London quotation. The following table gives the price of gold in London on the last Friday of each month from January, 1920 to the end of 1924 together with the London cable rate upon New York. The close similarity between the movements here indicated is observed by noting the relation of New York exchange to the reciprocal of the gold

PRICE OF GOLD PER FINE OUNCE IN LONDON, AND LONDON EXCHANGE
ON NEW YORK, 1920-24

Month	1920		1921		1922		1923		1924	
	gold s/d	exch. \$	gold s/d	exch. \$	gold s/d	exch. \$	gold s/d	exch. \$	gold s/d	exch. \$
Jan.	117/6	3.51	105/7	3.88	97/4	4.23 ³ / ₈	89/10	4.65	97/10	4.21 ³ / ₄
Feb.	121/8	3.37	106/4	3.86 ¹ / ₄	93/10	4.40 ³ / ₄	87/6	4.71 ³ / ₄	95/11	4.30 ⁵ / ₈
Mar.	105/8	3.90 ¹ / ₂	105	3.91 ¹ / ₂	95/4	4.37 ¹ / ₂	87/9	4.69 ¹ / ₂	96/1	4.30 ¹ / ₄
April	108	3.87	104/1	3.95 ¹ / ₂	93/3	4.42 ¹ / ₂	89/1	4.62 ³ / ₄	94/1	4.37 ¹ / ₈
May	105/5	3.90 ³ / ₄	105	3.91 ¹ / ₄	93/7	4.45	89	4.62 ⁵ / ₈	95/4	4.32 ¹ / ₈
June	103/7	3.97	110/5	3.73 ¹ / ₄	92/8	4.41 ¹ / ₄	89/11	4.58 ³ / ₄	95/4	4.33 ³ / ₈
July	109/9	3.75 ¹ / ₄	114/6	3.58	92/2	4.44 ⁷ / ₈	89/9	4.59 ¹ / ₄	93/10	4.41
Aug.	115	3.75 ¹ / ₂	111/6	3.69	93/10	4.47 ³ / ₈	90/8	4.54 ⁵ / ₈	92/1	4.48 ³ / ₈
Sep.	117/9	3.49	111	3.72 ¹ / ₂	92/8	4.37 ³ / ₄	90/7	4.55 ¹ / ₈	92/5	4.47 ¹ / ₂
Oct.	118/1	3.46 ³ / ₄	104/10	3.92	91/8	4.45 ¹ / ₂	92/1	4.49 ⁷ / ₈	91/9	4.52 ¹ / ₂
Nov.	117/7	3.48 ³ / ₈	102/11	4.00	88/11	4.49 ¹ / ₂	94/11	4.34 ¹ / ₄	89/10	4.63 ¹ / ₄
Dec.	116/1	3.54	98	4.20 ¹ / ₄	88	4.63 ¹ / ₂	94/10	4.35 ¹ / ₈	88/6	4.70 ¹ / ₈

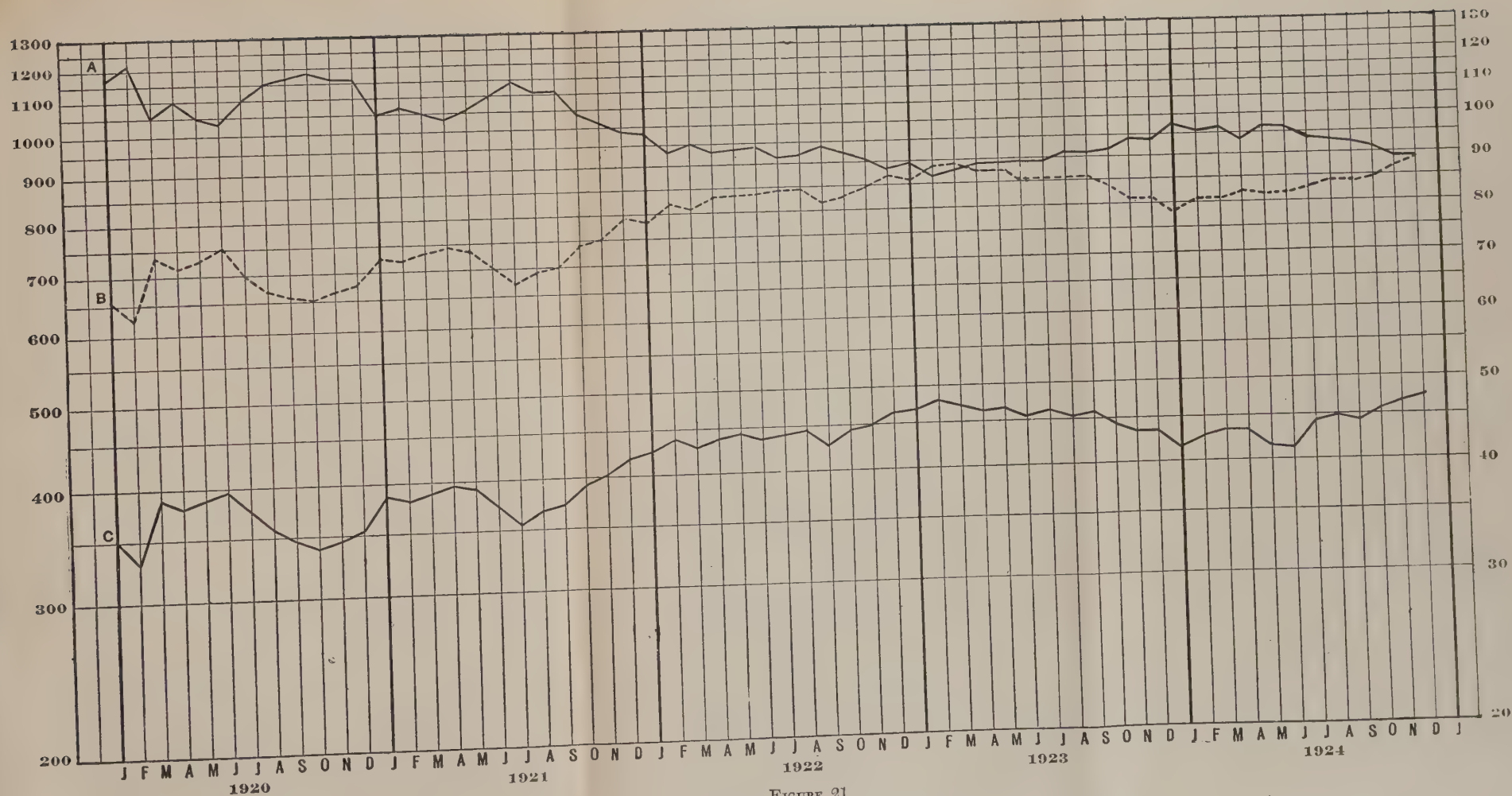


FIGURE 21

Line A. London price of one ounce of gold in pence, right-hand scale
 B. Reciprocal of above, right-hand scale
 C. London Exchange on New York in cents, left-hand scale

price, which represents at each date the gold value of the pound sterling, as depicted on the chart. An exact parallelism in all the minor movements is for reasons already indicated not to be expected. However an examination of the chart shows clearly a tendency towards uniformity in the major movements which the chart reveals. As in a previous chart, the scale used permits an exact comparison of relative changes since equal proportional movements are depicted by parallel lines or curves.

9. *Depreciation, theoretical and actual.*—The theory of international exchange under a depreciated paper currency offers little difficulty. It assumes that the amount of depreciation is definitely known, and that this establishes a new parity of exchange. For example, the mint par between the United States and France is 19.3 cents to the franc, and before the War exchange fluctuated within narrow limits about this figure. If we could ascertain with positiveness that French currency had suffered a depreciation of fifty per cent, then a new exchange parity of 9.65 cents to the franc would be established, and we should expect actual exchange to stand at about this point.

With this new exchange parity instead of the former mint parity we might reasonably expect the range of fluctuation above and below parity to be greater in extent, but we could judge from the daily quotations at any given time whether exchange was high or low.

Delightfully simple as this is in theory its practical application to any given situation presents considerable difficulty thru the fact that it is by no means an easy matter to determine exactly what the depreciation of the currency actually is. During the suspension of specie payments in the United States the price of gold gave an easily understood and generally accepted measure of the depreciation of currency. But in European countries of recent years there has as a rule been no definitely ascertained market price of gold, and where such a price has been obtainable the conditions have been such as to make it an inadequate measure of currency depreciation. It is not therefore available for the calculation of exchange parities.

10. *Purchasing power parity.*—We are therefore thrown back for the explanation of exchange rates between gold using countries and paper standard countries upon the purchasing power parity theory.¹ In general terms this too can be very simply explained. Under the gold standard, prices in New York and London are approximately the same in terms of gold, \$4.86 in New York will purchase about the same amount of goods as £1 sterling in London. Now assume that because of the weakened

¹ At this point and elsewhere thruout this volume the term purchasing power is used to denote the volume of goods purchasable at wholesale prices. It is of course understood that retail prices do not always follow closely wholesale prices in their rise and fall, and that the purchasing power of money in wholesale trade may change without this fact being immediately perceived by the consumer.

purchasing power of sterling the same quantity of goods can not be bought in London for less than 1£ 5s. It is obvious that the pound sterling measured in dollars has become of less value and instead of being the equivalent of \$4.86 it is now worth only \$3.888. In this illustration it is assumed that the price of the goods in New York remained the same. Suppose, however, that the price of goods advances in New York to \$5.887 and in London to 1£ 10s. The ratio between these figures again indicates the value of the pound sterling as \$3.888. In other words the ratio of value between American gold and British currency is determined by the ratio existing or anticipated between British prices and American prices tho, in practice, one must allow for time for adjustment and for lack of information among dealers. Moreover, the ratio between prices is often if not usually anticipated by the exchange dealers.

To state this principle in general terms is one thing; to determine exactly what this price ratio may be at any given time is another. The means available for this purpose are the well known index numbers of prices in different countries. They are not of course above criticism and indeed much has been written of late as to a better construction of such measures. It is possible that much remains to be done to give them exact mathematical precision but recent criticism has not impugned their approximate accuracy or impeded their increasing use in the discussion of economic problems.

Exchange rates and price levels are then different reflections of the same group of phenomena and we should expect them to reveal like tendencies. Price levels are perhaps the more important of the two things, affecting as they do all internal commercial relations, and we should therefore expect them to govern the exchange rates altho they often follow in time.

In the main this is the case, tho we fail to find the exact correspondence which purely theoretical considerations might lead us to expect. We can merely say that this is a theoretical normal rate of exchange somewhat imperfectly ascertained, toward which real rates tend to adjust themselves. Mr. S. Stern, then Vice-President of the Columbia Trust Company in New York, made in 1921, some interesting calculations as to the probable rate of exchange for the purpose of comparing his results with the actual exchanges. The following table reproduces in part his statements regarding France.

Date	I	II	III	IV	V
	Price Index	Price Index	Per Cent	Exchange	Actual
	U. S.	France	premium	quotation	average
	1913 = 100	1913 = 100	on \$1	correspond-	monthly
			goods in	ing to	exchange
			France	premium	(cable)
				Cents	rate
					Cents
1918 Oct.	204	360	76	10.9	18.3
1919 Jan.	202	348	73	11.1	18.3
Apr.	203	332	64	11.1	16.7
July	219	350	60	12.0	14.4
Oct.	223	384	73	11.1	11.6

Date	I	II	III	IV	V
	Price Index	Price Index	Per cent	Exchange	Actual
	U. S.	France	premium	quotation	average
			on \$1	correspond-	monthly
			goods in	ing to	exchange
			France	premium.	(cable)
	1913 = 100	1913 = 100			rate
				Cents	Cents
1920 Jan.	248	489	97	9.7	8.6
Apr.	265	591	123	8.6	6.3
July	262	496	89	10.2	8.1
Oct.	225	502	123	8.6	6.5
1921 Jan.	177	406	129	8.4	6.5

Col. I U. S. Bureau of Labor statistics

Col. II Statistique Generale de la France

Col. III obtained by subtracting Col. I from Col. II and dividing the difference by Col. I

An examination of this table shows that in the earlier dates the actual exchange was well above the calculated exchange rates based on price levels; in the later dates it falls below that ratio but not to so marked a degree. The Bank of France in the earlier period made strenuous efforts to maintain the franc in foreign exchange. Later the figures correspond more closely to the normal course of the market.

11. *Unusual influences in the exchanges.*—The story of foreign exchange during and to some extent subsequent to the War period is complicated at every turn by governmental pressure seeking to divert or suspend the workings of the ordinary economic laws. From 1914 until after the Armistice it was govern-

ment rules and policies rather than commercial needs which dominated the exchange situation. From the detailed story of the exchanges during the period it will suffice to pick out one or two leading incidents which serve to illustrate the point.

12. *The European moratoria.*—The outbreak of the Great War in 1914 was followed almost immediately by the proclamation of moratoria in the European nations. In other words, by official action the payment of all debts was postponed. Combined with the other unusual conditions of the moment this measure had a disastrous effect upon New York exchanges.

The situation at the beginning of July was not unusual, but not particularly favorable. At this season exchanges on London usually runs high and is kept down by drafts in anticipation of fall exports of grain and cotton. In 1914 it happened that in addition some important bond issues largely held abroad were due for payment.

With the outbreak of the War there was a mad scramble to cover. The New York Stock Exchange remained open longer than the exchanges of Europe and large quantities of American securities were sold by their European holders. At the same time commerce on the high seas was paralyzed and our exports fell off. Europe and particularly London was insistent upon the immediate payment of all demand obligations and refused to extend or renew loans.

All these things combined to make an extraordi-

nary demand for European exchange at the same time that we were unable to establish credits against it. On top of all this came the moratoria of the European powers, which rendered for the time being unavailable such credits as we possessed in the European markets.

The situation even before the war clouds appeared on the horizon in the latter part of July was one that called for gold shipments and they were made in large quantities. With the threat of hostilities exchange rates rose rapidly and London cables rose before the end of July to \$6.35. In the early days of August there were a few transactions of this nature at rates of \$7.00 or even more for the pound sterling. The insecurity of the seas made further gold shipments exceedingly dangerous and expensive.

After the first panic the situation gradually ironed itself out, tho sterling was above par until the end of the year 1914. In the meantime trade was getting upon its feet again. The enormous demands of Europe for supplies of all sorts restored and heightened the usual excess of merchandise exports. This, combined with the lapsing of the moratoria in the different European countries, supplied ample credits against which exchange could be drawn.

13. *Artificial aids to exchange.*—It was not long, however, before the situation of the early days of the war became reversed. The large purchases of supplies by the Allies created such an enormous supply of foreign exchange that it fell below par, sterling in

1915 having gone down to \$4.50. This meant an enormous increase in the cost of carrying on the war. At low rates of exchange, Great Britain which bore the brunt of war financing, was forced to give more sterling for everything which was purchased in the United States.

To meet this situation the British government entered on plans to stabilize the rate of exchange and in the parlance of the day "pegged" it at \$4.75. This price represented approximately the import gold point under the existing conditions of unusual expense in gold shipments. The British government in short used its financial power to sustain the exchange market, buying exchange at the point chosen to any extent necessary and keeping the price at this point. It was a very costly proceeding, but in the long run probably saved all that it cost in keeping down the prices of the supplies which the government was obliged to purchase. The example set by Great Britain was followed by France and to some extent though less successfully by Italy. The war period was on the whole one of artificially sustained exchange, which dropped from its high estate in 1919 when various governments discontinued their support.

In his work on "Foreign and Domestic Exchange," Professor Ira B. Cross gives an interesting account of the course pursued at this time by Great Britain.

England's pegging arrangement consisted of four parts; first, the mobilization of English-held American securities and the use of the funds received from their sale in the United

States in the purchase of sterling cables, thus artificially creating a demand for English exchange and stiffening the rate; second, the securing of loans and the establishing of credits in the United States, thus reducing the supply of sterling exchange; third, gold shipments; and fourth, regulations looking toward the restriction of unnecessary imports.

In July, 1915, England had organized the Committee on American Dollar Securities, but nothing was done toward the mobilization of such securities until the close of that year. England then appealed to her citizens, and especially to the insurance and trust companies, either to sell to the government or to loan to it their holdings of American securities. In case of sale, payment was to be made in five-year 5 per cent Exchequer bonds, the price of the securities being fixed at the New York quotation converted at the prevailing exchange rate on the date of sale. This arrangement permitted the holders to profit by the depreciation in the sterling rate in the United States. If the securities were loaned to the government, the owner was to receive the regular interest and dividend payments thereon, plus an additional return of one-half of one per cent per year from the government. At first the loan was to be for only two years, but it was subsequently extended to an indefinite length of time. The owner was also given the privilege of requesting the Treasury at any time to dispose of the securities in New York and to pay him the proceeds converted into sterling at the prevailing rate. Canadian and South American issues were also mobilized, but were employed chiefly as collateral for loans which we later advanced to England.

England experienced great difficulty in securing a sufficiently large supply of securities for her purpose. Holders were reluctant to part with their high yield American stock and bonds. The government was finally compelled to resort to force, and on May 29, 1916, passed a law imposing a special tax of 2s. per pound of income received from all issues asked for by the government. The Income Tax Act of 1916 also included a one per cent tax on United

States securities held by non-resident aliens. After January 1, 1917, this was further increased to 2 per cent. But even so, a sufficient amount of the desired securities was not forthcoming, and under the provisions of the Defense of the Realm Regulations, the Treasury was given power to compel the holders of certain issues to turn them over to the government. This final regulation was most effective, and the government experienced no further difficulty in obtaining the needed securities.

The method of employing the mobilized stocks and bonds was very simple. As sterling weakened in New York, the American agent of the English government (J. P. Morgan & Company) went into the market, sold a sufficiently large amount of the securities, and then with the proceeds purchased cables on London until the rate was forced back to its pegged position, which represented about a two per cent discount on the par of exchange. The rate determined upon was $4.76\frac{7}{16}$ for cables, which meant that sight sterling was expected to fluctuate between 4.75 and 4.76. This rate was a trifle lower than the point at which it would pay to import gold, but the risks of capture or loss by submarine were so great that England knew that American bankers would not be active as importers of the yellow metal.

After our first loan to England and France in 1915, it was only a short time until the Allies were in the American market for additional advances. All the loans subsequently made were dollar loans, the proceeds being deposited in American banks and drawn on by American exporters. The extent of the loans privately floated, as well as the amount of credits advanced by the United States government after we entered the war, have been fully commented upon elsewhere. Their effect was, in brief the curtailment of exchange of all kinds on the Allied nations. Sterling, franc, and lire drafts were no longer drawn as before; in their stead American exporters drew drafts in dollars on the accounts of the Allies which had been deposited in New York banks. This extensive reduction in the supply of exchange helped materially to stabilize the exchange rates.

Immediately upon the outbreak of the war, England, France, and Russia pooled their gold resources in order that their funds might be made more effective. The control of the gold was placed with England, who was to use it in such a way as to keep the exchange rate pegged and the American money market in an "easy" condition. Some of this gold came across the Atlantic convoyed by warships; some across the Pacific. The greater part was sent direct to Ottawa. From time to time, as the exchange market stiffened, or as money rates in New York gave evidences of rising, this gold was sent to the United States, its arrival being nicely timed to have the desired effect. By this means, the Allies were able to keep the exchange rate at the desired position and the money rates lower than they would otherwise have been.

England and the other allied countries also succeeded in placing an effective embargo upon unnecessary imports and so reduced the amount of exchange that would otherwise have been drawn in connection therewith. Not only were luxuries placed under the ban, but an effort was also made to allow only the required amount of the necessities to be imported.

REVIEW

Explain why the lack of a common monetary standard is no bar to trade between the nations.

How is the adjustment of trade balances effected?

What purpose is served by giving in exchange quotations the mint par (a) when both nations are on a gold standard (b) when one of the nations is on a paper standard?

Describe two methods by which the gold value of paper currency is usually ascertained.

Explain the purchasing power parity theory of international exchange.

Why did sterling exchange rise enormously in the first months of the Great War and what caused its subsequent fall 'till the British government undertook its "pegging" operations?

Describe those operations.

CHAPTER XVII

PAPER STANDARD EXCHANGES AMONG PAPER USING COUNTRIES

1. *Are paper standards comparable?*—The exchanges between a gold country and a paper using country have the appearance of a certain stability thru the fact that the value of one of the currencies seems to be fixed with reference to an article universally desired, namely gold. When exchanges take place between two countries each of which has a different paper standard it would appear at first sight as if there were nothing to connect them, and as if it would be extremely difficult to establish relations between them.

The situation is not so complicated as it seems. Generally speaking, paper money derives its value from the fact that it is redeemable. Under the gold standard it is directly redeemable in gold. When convertibility ceases to exist, there is sometimes an indirect convertibility into gold thru purchases in an open market. But whether or not this is possible, paper money so long as it continues to function as money may, without too great violence to the language, be said to be redeemable in goods.

Therefore the paper money of two different coun-

tries may be directly measurable in terms of gold thru bullion purchases in domestic markets. Or they may be measurable one against the other in terms of gold thru the fact that each has definite relations thru international exchange with a third country which has a gold currency.

Back of the relations of each to the gold using country lies, as we have already seen, the purchasing power which resides in its currency. Two things which can be related to the same thing can of course be related to each other, and thus we have the possibility of comparing such different things as paper francs and paper lire.

2. *When gold is purchasable in domestic markets.*—If gold is freely purchasable and freely salable in the domestic markets, the relation of one paper currency to another is readily ascertained. If in country A 100 units of local currency will buy a certain quantity of gold, and in country B 200 units of local currency will buy the same quantity of gold it is obvious that the par of exchange is one A unit for two B units. Actually exchange will fluctuate about this rate. If for one reason or another the exchange rate in A on B should fall to the point when one A unit would purchase less than two B units, the time would soon come when it would be preferable not to purchase exchange on B, but to buy gold and ship it to that country. Conversely if the people of B had to pay more than two units of B currency for one of A currency, they in turn would at a certain point re-

sort to purchase of gold and its sale in the markets of A.

The illustration of the principle here involved is purposely given in rather general terms. Had it been sought to exemplify the general principle by reference to conditions actually prevailing it would have been found that the assumptions of the comparison did not in fact exist. Suppose for example the effort had been made to explain in this manner the London rate on Paris at the present time. It has already been noted that the gold market in London is not wholly free and that gold is quoted there at prices higher than in New York by more than the cost of transporting gold. In Paris gold transactions are even more infrequent; they are to a considerable extent more or less secret, and definite gold quotations are not regularly obtainable. In other words the same causes which in the first instance lead to a depreciation of the currency in terms of gold, will as a rule prevent the establishment of a free gold market.

3. *Comparisons with a third currency.*—The absence of a domestic market for gold may be in part compensated by the existence of a foreign market for that metal. Thru the exchange rates of New York on London and Paris the pound sterling and franc are both rated in American dollars, and this makes possible a comparison between them.

A simple illustration will serve to show the operation of this principle and the limitations to which it

is subject. On July 5, 19— the New York cable rate on London was \$4.78 $\frac{11}{16}$ to the pound sterling and that on Paris was 3.90 $\frac{9}{16}$ cents to the franc. Par on the gold basis being \$4.8665 for sterling and 3.91 $\frac{3}{4}$ cents for the franc, it can be easily computed that in New York, the pound stood at that date at 98.4 per cent of par, and the franc at 99.69 per cent of par. What was the relation of the franc to the pound sterling? Evidently $99.69 \div 98.4$ or 1.012 per cent of the sterling par. The latter is in normal circumstances 123.93 francs to the pound. But if under present conditions this quantity of francs represents 99.69 per cent of the value of the pound, the latter is worth 123.5458 francs.

We should then expect exchange between London and Paris to approximate the figure above calculated. Both London and Paris quote exchange on the basis of francs to the pound.

The correspondence between the probable rate calculated on the basis of New York exchange and the actual rate is as close as could be expected. Wherever different monetary standards prevail, however, the general level of the exchanges will of course be determined by the various respective values of their particular currencies. But other considerations drawn from the position of commercial affairs on the other hand enter into all actual rates.

In our illustration there are unknown and unmeasured factors affecting each of the four rates used for the computation: New York on London,

New York on Paris and two rates between London and Paris.

The New York exchange rate is now the universally acknowledged key to an understanding of the relative values of the varied currency units of the Old World. As we have seen, it serves to explain the more obvious features of foreign exchange between different nations, but it fails to account for those minor variations which under the normal conditions of the gold standard are the essential features of exchange relations. These can in fact only be mastered by those who are in daily touch with the exchange situation, and are thus enabled to estimate and appreciate how far its daily fluctuations correspond to changes in the purchasing power of the units and how far they reflect changing conditions of debit and credit between the nations.

4. *Further illustrations.*—That the use of New York exchanges as a connecting link between the currencies of different paper standards may be thoroly understood a further illustration may be considered in the case of France and Italy. After the war, both were under a paper money régime with different degrees of depreciation in comparison with the same gold unit, known in France as the franc, in Italy as the lira. Of course in normal pre-war exchange 100 francs equalled 100 lira. What should be the relation of the units to one another today? On January 30, 1925, the New York cable rate for the French franc was

5.41½ cents, for the Italian lira 4.16 cents. Hence in New York 1 lira equalled 0.7682 francs and we should expect to find this ratio reappearing in the exchange relations between Paris and Italy. Paris quotes Italian exchange in francs per 100 lire and we find the cable rate on the previous day to have been 77.22 francs or about one-half a franc more than the equivalence here calculated.

The use of exchange on gold using countries is in most cases the best available means of measuring the departure of a paper currency from its former mint parity. An official publication of the Austrian Government (*Statistische Nachrichten*, April 23, 1923), for example, gives figures to be used in translating the values of the Austrian crown to its gold equivalent for the period since 1914. Before May, 1919 this figure is based on exchange on Switzerland and after that date parallel figures based on Swiss exchange and New York exchange are given. Tho parallel, the two series are not identical because Swiss exchange on New York has not been uniform. The publication observes, however, that for the period since the early part of 1919 preference is to be given to the gold equivalents based on dollar exchange.

5. *Purchasing power of paper money.*—Gold coin as we have seen may wander from country to country and without changing its form and may as bank reserves serve the purpose of money in any of them. Paper money is practically non-exportable tho in

small amounts for the convenience of travelers and as a matter of speculation it is sometimes sought in foreign countries. The general rule, however, is that outside of the country in which the law gives it currency almost no one wants it.

If in these chapters we have spoken of the New York value of the pound sterling and the franc it is to be understood that, fully expressed, the phrase means the value in New York of the right to receive a pound in London or the right to receive a franc in Paris. Obviously to the New Yorker the pound in London and the franc in Paris have no value except for the fact that they can be used to buy goods, or pay debts in their respective countries, or for speculation. There has been much speculation in European currencies by those who hoped to gain by the fluctuations in their values. Thus we see that New York exchange is primarily only a reflection, or at times an anticipation of the relative purchasing power of the currencies, and it is so frequently referred to because it is perhaps the clearest available reflection or anticipation of that purchasing power. But it would be an error to mistake the image in the glass for the object which is mirrored there.

If then we can obtain a direct measure of purchasing power we shall get back of the forces which dictate the general levels of exchange rates. Thru the use of index numbers we can do this with a fair approach to accuracy. It should, however, be borne in mind that the index numbers represent different

goods bought in part under different circumstances and that exact comparability is not attainable.

6. *Prices and purchasing power.*—Price indexes show the relative prices of commodities at different periods in comparison with some definite price which, at least for the purposes of the comparison, is considered a normal price. It is customary in recent years to estimate price levels in comparison with those which prevailed before the Great War. If prices for example stand now at 200 in comparison with 100 in 1913, it is obvious that \$200 will be required to purchase goods which could have been bought in 1913 with \$100. The dollar then has only half the purchasing power of the former period. When prices fall, the dollar will buy more and gains in purchasing power. Hence the index of purchasing power is the reciprocal of the index of prices. In the following table are given the price index of commodities compiled by Bradstreet transposed so as to make the year 1913 correspond to 100 and the corresponding index of purchasing power.

$$1913 = 100$$

		Purchasing Power
1913	100	100.0
1914	97	103.1
1915	107	93.5
1916	128	78.0
1917	170	58.8
1918	203	49.2
1919	203	49.2

	1913 = 100	Purchasing Power
1920	204	49.0
1921	123	81.3
1922	131	76.3
1923	145	68.97
1924	153	65.36
1925	159	62.89
1926	140	71.42
1927	139	71.94

The two series are merely two different expressions of the same set of facts, tho the former is of more frequent use. For present purposes the second series is the more important. It may help to fix its exact meaning by considering it to represent in each year the value of the dollar measured in pre-war cents.

It has already been observed (Chapter XIV) that variations in the purchasing power of money are characteristic of the gold standard as well as of other monetary standards. The point to be emphasized here, however, is not that gold changes in value, but that the up and down movements of prices are closely parallel in the countries using gold as the standard. In pre-war days, prices measured in dollars, pounds, francs or marks, moved upward and downward nearly together. A chart of the index numbers for the leading nations shows only minor differences in the trend of price movements. In recent years this has changed because in many of the leading nations the monetary unit has lost its connection with gold.

Since 1915 price changes have been greater in some countries than in others (See table on p. 263) and rarely has the degree of change in one country corresponded to that in another. The causes of these changes do not concern us here; we are concerned with the respective levels, and these may be conveniently studied in detail for the year 1922. Prices and purchasing power are shown by months in the following table (1913 = 100 in each case).

	Gr. Britain		France		Italy	
	Prices	Purchasing Power	Prices	Purchasing Power	Prices	Purchasing Power
1922 Jan.	156	64	315	31	602	16
Feb.	155	65	308	32	586	17
Mar.	157	63	309	32	555	18
April	159	63	315	31	549	18
May	159	63	318	31	545	18
June	160	62	327	31	560	18
July	158	63	327	31	580	17
Aug.	152	66	333	30	595	17
Sept.	150	67	331	30	606	16
Oct.	153	65	339	29	626	16
Nov.	154	65	354	28	621	16
Dec.	152	66	364	27	604	16

An examination of the table shows that, roughly speaking, the purchasing power of the pound sterling was about two-thirds of what it was before the War, that of the franc about one-third and that of the lira about one-sixth of its pre-war equivalent. In the brief period of one year changes are not so marked as if more distant dates were selected. However, it will be observed that the purchasing power of the pound sterling in the main improved, that of the franc decreased and that of the lira, after showing some gain, went back to its starting-point.

7. *London exchanges.*—What makes the rate of London on Paris or on Italy what it is? In a broad way the foregoing table gives the answer to the question. British purchasing power in January, 1922 for example was in round numbers 64 per cent of its pre-war position, French purchasing power only 31 per cent of its former position. Shifting the comparison the purchasing power of the franc compared with that of the pound sterling appears to be 48 per cent of the latter ($31 \div 64$). With both pound and franc freely convertible with gold the unit par between the two countries is one pound sterling equals 123.93 francs. If, however, in January, 1922 the purchasing power of the franc was only 48 per cent that of the pound sterling it took of course a large number of francs to equal one pound, and the calculated equivalence was 52.75 francs.

In analogous manner we find that in January, 1922 the purchasing power of the lira in Italy was only 16 per cent of what it was before the War. Since, at the same time the purchasing power of the pound sterling had declined to 64 per cent, the lira had at the date mentioned exactly 25 per cent of the purchasing power of the pound. If normally the pound was equivalent to 25.225 lire, it is obvious that under the conditions named it would require four times as many lire or 100.90 to purchase the equivalent of a pound's worth of goods.

This relative purchasing power of the currencies should then give the normal relation of one to an-

other in exchange. If we could calculate the purchasing power parity with mathematical accuracy we should expect a close agreement between the calculated parity and actual exchange rates. The available statistical material gives us price indexes at the best by monthly averages while exchange rates are quoted daily, and those of foreign centres are not easily accessible. In making a comparison for the year 1922 between the computed parities and actual exchange rates the latter have been taken at the figure given in the weekly foreign papers for the date nearest the middle of each month. The table which follows shows relative purchasing power between Paris and Italy on the one hand and Great Britain on the other, the theoretical par of exchange and the actual exchange rates.

London and Paris

London and Italy

1922 Month	Relative Purchasing Power of the Franc per cent	Estimated Par of Exchange Francs per pound sterling	Exchange (Cables) Middle of Month	Relative Purchasing Power of the Lira per cent	Estimated Par of Exchange Lira per pound sterling	Exchange (Cables) Middle of Month
Jan.	48	52.75	51.90	25	100.90	97.39
Feb.	49	51.48	50.05	26	97.01	89.62
Mar.	51	49.46	48.50	29	86.96	85.87
Apr.	50	50.45	47.90	29	86.96	88.12
May	50	50.45	48.70	29	86.96	84.00
June	50	50.45	50.87	29	86.96	89.25
July	50	50.45	54.30	27	93.42	89.25
Aug.	45	56.06	56.07	26	97.00	98.62
Sept.	45	56.06	58.20	24	105.10	105.12
Oct.	45	56.06	58.50	25	105.10	104.25
Nov.	43	58.66	63.75	25	100.90	95.75
Dec.	41	61.52	63.60	24	105.10	91.87

The first column relating to France shows in the latter part of the year a decided falling off in the purchasing power of the franc compared to that of the pound. It thus reflects the combined effect of the facts, already noticed in a previous table, that while the purchasing power of the franc declined that of the pound rose. In like manner tho the lira had the same purchasing power in Italy in December as in January, it had less purchasing power in England compared with the pound, because the position of the latter improved.

London quotes exchange on France and Italy on the basis of the foreign units obtainable for the pound sterling and the computed par of exchange based upon relative purchasing power is calculated in the same fashion. The calculation is approximate only and does not reflect from month to month the minor variations observed in the exchange market which is always more sensitive than the commodity market. Yet on the whole and allowing for differences of method the correspondence between the columns is sufficiently marked to establish the proposition that ultimately it is the purchasing power of the different monetary units in their respective countries that governs the exchange relations between them. The table shows that when the computed par remains the same as in the preceding month, the exchange for the month (middle point) does not show a like uniformity. When, however, the computed par changes the exchange usually follows it.

8. *Paris exchanges*.—The relation of Paris to London stated in the previous section is one of a considerably depreciated currency to another much less depreciated. The relation of Paris to Italy on the other hand brings into comparison two countries both of whose currencies are considerably depreciated. From the table previously given we can compute the relative purchasing power of the lira in terms of the franc, and the theoretical par of exchange. Since Paris quotes the number of francs paid per 100 lira the two figures are identical. Our table which follows is therefore simpler.

Paris and Italy

1922 Month	Relative purchasing power of lira in terms of franc per cent	Estimated par of exchange francs per 100 lire	Exchange (cables) middle of month
Jan.	52	52.00	52.25
Feb.	53	53.00	56.50
Mar.	56	56.00	56.50
Apr.	58	58.00	58.38
May	58	58.00	57.62
June	58	58.00	56.40
July	55	55.00	55.50
Aug.	56	56.00	57.00
Sept.	53	53.00	55.60
Oct.	56	56.00	56.50
Nov.	57	57.00	68.40
Dec.	59	59.00	70.30

Since Italian currency had gone down further in purchasing power than the French its relative pur-

chasing power was considerably below the equality of the pre-war period. It is to be noted, however, that it bore a greater relation to French money than either French or Italian money bore to the value of the pre-war currency. The table shows that Italian money stood during 1922 at between 50 to 60 per cent of French money, and the actual exchange was usually effected at those figures. The figures for actual exchange rates follow in general the same course as the estimated purchasing power.

9. *Sensitiveness of the exchanges.*—In the foregoing analysis the effort has been made to get at the causes which lay behind the variations in the exchanges of two paper using countries. This fundamental background was found in the relative purchasing power of these currencies in the home market. It would lead beyond the scope of the present volume to discuss in detail the various factors which determine this purchasing power. It is evident that among other things confidence in the ability of the government to sustain the value of the currency is a prominent element in determining its purchasing power. Where confidence is lacking the spur to industry slackens, the demand for the service of money is curtailed and this acts in the same way as an over-supply to lessen its value.

A fact which at first blush seems to be somewhat at variance with the position taken here is the complaint heard frequently in recent years that exchange rates have in various instances changed in a marked

degree before local prices have risen and that through this the foreign buyer has been favored at the expense of home merchants. The movement of prices is not equally rapid among all commodities. Some respond quickly, others sluggishly to the changes in the value of money. Exchange is one of the most sensitive of prices. Its movements anticipate rather than follow in time the price changes in the commodity market. It does not, however, follow from this, as it appears superficially, that changes in exchange are the causes of changes in prices. On the contrary both are expressions of the same underlying causes. The foreign exchanges which represent a comparatively small element in the nation's business, except in a country like Great Britain, are not the dominant element in producing the economic changes which they reflect.

REVIEW

Explain how the price of bullion or exchange on a gold country can be used in determining relative values of currency of two paper using countries.

Explain why under present conditions New York exchange has become the measuring stick of all currencies. Give illustrations.

How is purchasing power measured? What significance for the exchanges has the relative purchasing power of two currencies?

Show why in 1923 Paris rates on Italy departed less from normal par than did Paris rates on London.

CHAPTER XVIII

NEW YORK AND LONDON AS FINANCIAL CENTERS

1. *New York's prominence in world finance.*—The Great War in Europe, besides making the United States a creditor nation, threw upon New York City, its financial centre, a great burden of financial responsibility and gave rise to the belief in many quarters that New York City was destined to be henceforth the world's financial centre. For several centuries before the war, London had admittedly been the centre of the world's financial operations. Is it possible that New York in the near future, because of the advantage given her by the war, may wrest the title from London and hold it for centuries to come?

2. *What makes a financial centre.*—Many circumstances have combined in the past to give London its supremacy in finance. Its geographical position midway between the eastern and western markets, its exports and imports carried in English bottoms to and from all the world's ports, its sound monetary system, a sterling bill for a century having been regarded as the equivalent of gold, its liquid discount market, its relatively low and stable rate of interest, its large investments in foreign countries and the high reputation for business honor and square dealing en-

joyed by English bankers and traders thruout the world, were among the most important circumstances that contributed to the making of the sterling bill practically equivalent to a world medium of exchange.

Of the circumstances mentioned in the foregoing paragraph at least three are today absolutely essential.

First.—No city can become or long remain the world's financial center unless it is in close commercial touch with practically all the nations of the earth.

Second.—Its monetary system must be one which enjoys the confidence of the world in its character and stability. For the last century this has meant generally a gold currency.

Third.—It must have a liquid discount market.

Any city possessing these conditions will always be a dangerous rival of London even tho the latter city as the years go on regains its supremacy.

And any city possessing these fundamental advantages will, as it gradually acquires leadership in world finance, at the same time acquire the diversified and freer banking system, the high credit standing with foreign nations, numerous branches in foreign countries, and the large mercantile marine for which England has been noted in the last two centuries.

3. *Finance follows trade.*—The old saying that trade follows the flag does not express so important a truth as the statement that finance follows trade.

Because of this London became the world's finan-

cial center. England's insular position with a territory able to support only a comparatively small population compelled her centuries ago to become the world's workshop, importing raw materials from all quarters of the globe and exporting them in a great variety of manufactured articles, most of them famous for their honest workmanship. Her business leaders encouraged the building of ships because they wanted proper markets for English wares, and freedom of trade, first advocated by Adam Smith in 1776, was adopted by England early in the last century because it was recognized that exports and imports must increase together and that taxes on imported raw materials increased the English manufacturer's cost and tended to place him at a disadvantage with foreign competitors.

It is doubtless true that England might not have gained her enormous world trade and her financial leadership had she not in the beginning encouraged shipbuilding and sent her flag into the harbors of all the seas. Yet the essential cause of her leadership in finance was her world trade and not her great merchant fleet.

4. *World exchange must mean gold.*—It is common knowledge that people are perfectly willing to accept paper money or checks and drafts in payment for the goods they sell, provided they are quite confident that this paper can be exchanged for gold if desired, and so long as such confidence prevails nobody thinks of asking for the gold. But nobody

wants anything to do with a promise to pay which is tainted with uncertainty. Such paper can get into circulation only at a discount.

So no city can become a world leader in finance unless merchants and bankers are everywhere convinced that drafts on that city will be promptly met and paid in gold. If thruout the world there is distrust of its monetary or banking system, it cannot become a world financial center no matter how great its exports and imports. England before the War had long been on the gold basis and London had long been the world's freest gold market. Sterling bills of exchange were bought and sold in the United States, in China, in South America and in all other countries where trade had risen above the level of barter, and every buyer had absolute confidence that his bills could instantly be exchanged in London for gold, or be used for the payment of debts in London quite as effectively as gold itself. The War, however, threw England off the gold basis just as did the Napoleonic Wars over one hundred years ago and London immediately lost its world's supremacy in finance.

5 *Liquid discount market.*—The reader will realize from his knowledge of banking that it is practically impossible for a country to possess a discount market unless its financial operations are stabilized and supported by one or more very powerful banking institutions, and that in most of the countries of Europe such markets have been built up because of

the existence of large central banks, many of them government owned or controlled. The Bank of England, established in 1694, is privately owned and controlled, but it enjoys certain exclusive privileges which compel it in self defense to assume all the responsibilities of a government bank, so that within certain limits it has become a regulator of the London money market and a source of relief to London banks in times of stress. Hence London before the War had developed the most sensitive and liquid discount market in the world. Bills and securities of all kinds found in London a readier market than in any other city. It was the world's market for capital. In that city one found the greatest lenders and the biggest borrowers. To convert a bill of exchange into gold was as easy as it is to cash a check in an American bank.

6. *New York's advantages.*—London lost for a time its commanding position in finance, when a sterling bill and paper pound did not mean a definite quantity of gold. During the War and in the first years after the Armistice the gold value of the paper pound fluctuated so rapidly and violently that few people had any idea what the quotation would be the next day, to say nothing of next week. For example in the year 1920 sterling exchange varied from \$3.19 to \$4.06 $\frac{2}{3}$ and, in the two months of January and February, 1921, between \$3.53 $\frac{1}{4}$ and \$3.92.

Later the fluctuations became less marked and the margin between the value of the paper pound and

the gold sovereign shrank to such small limits that Great Britain regained much of its former influence in world finance.

New York now possesses two of the conditions essential to leadership, namely, a sound monetary system on the gold basis together with a free gold market, and a federal banking system that is rapidly developing a liquid discount market. Unhappily the foreign trade of the United States in the past has not only been carried in foreign ships but has not had a world-wide distribution. The bulk of our exports before the War went to Europe, and some of our exporters were not always conscientious in their efforts to have their goods correspond honestly with specifications and promises. Furthermore, during the last century we indulged in some financial and monetary experiments which made many foreigners suspicious of our financial sanity. For these reasons in some of the world's market places and banking circles "dollar exchange," as drafts on New York are called, are looked upon rather dubiously. If New York is to hold its newly acquired leadership, no effort must be spared to win foreigners' confidence in America's determination to maintain the gold standard, in the honesty of American manufacturers, in the fundamental soundness of our banking system and in the absolute freedom of our gold market. Even then New York may lose out in the race with London now that England is back on the gold basis, if unwise legislation hampers the growth of American shipping, or

if high tariffs raise the costs of American products and arouse resentment in the bosoms of our best customers.

As a creditor nation the United States must in the not far distant future become a heavy importer of foreign made goods. To many Americans this prospect is not pleasing, and there is little doubt that it will be the subject of much debate during the coming years. In this connection we can be certain about one thing, namely, that New York City cannot long remain a world center in finance if ships laden with the world's goods do not find a welcome off Sandy Hook.¹

7. *Physical conditions favorable to London.*—London is situated on the threshold of Europe in the heart of the world's commercial activities, directly opposite the estuary of the Scheldt and nearly opposite that of the Rhine, and is within a short distance of every important exchange center in the world with the exception of New York. This may be considered as an almost insuperable obstacle to New York's ambition.

London has the advantage of water lanes free from ice and fog to every large port in the world with the exception of New York; the climate is equable and liquids and perishable goods run little or no danger of freezing in winter.

The restricted insular area of Great Britain, a

¹ Sections 7 to 12 of the present chapter is taken by permission of the publishers from an article by Mr. E. L. Stewart Patterson, published in the *Annals of the American Academy of Political and Social Science*, November, 1916.

little larger than the State of Minnesota, is also an important factor, as it not only affords an immense seaboard compared with its size, but concentrates the population. A frequent and rapid transit service makes Great Britain practically one large city with London as the business center. Every bank in the country has a branch or correspondent in London, carries its reserves there and clears direct with every part of the country thru its London agent. The economy of resources effected by this natural concentration of funds is seldom realized and is worthy of study. The insular position of London renders it comparatively free from the danger of invasion and seizure by a hostile power and this immunity has been a factor in making London a world depository.

8. *Mail and cable facilities.*—The geographical situation of Great Britain, coupled with her willingness to invest money in international utilities, has placed her in a unique position as regards mail and cable facilities. Thru her immense mercantile navy, London has direct communication by fast steamers with every important port in the world and consequently acts as a foreign mail clearing house for all other countries. If French, German, or Dutch steamers afford a faster service to any point they can be utilized with little or no loss of time.

As Great Britain owns and operates two-thirds of the submarine cable mileage of the world, it is natural that London should be a great cable center with practically direct communication the world over. This

service is now supplemented by a far flung system of wireless stations. Furthermore, under normal conditions, every main railroad on the continent of Europe gives its best service and equipment to its London mail train. The Trans-Siberian Railway already gives access by rail to the Pacific and it is only a question of time before thru connections with India, China and South Africa will be established.

9 *Time advantages.*—In dealing in foreign exchange and stocks London is the center of the world as regards time. She knows the conditions in eastern markets before they close and is open long enough to operate in New York before her own markets close. Her position is therefore pivotal as regards time and distance. Time is the essence of an exchange transaction; a day's delay may turn a profit into a loss and, granting that New York has the means and enterprise to create an efficient steamship and cable service in due course, how can she eliminate the more serious handicap of distance by water from all other financial centers?

10. *National characteristics.*—Great Britain is a land of slowly acquired fortunes, and the banker and merchant there are content with small profits and slow returns. They have long realized the fact that trade follows the loan and have, therefore, been willing to invest money in foreign countries with no prospect of recovering immediate returns or large profits. The financing of these loans abroad has been an im-

portant factor in making the London money market so supreme. It is doubtful if the American is adapted temperamentally for operations of this kind or for the small profits of the exchange operations connected therewith. The United States has still a vast area in proportion to its population, its natural resources are not yet fully developed and it is a country of large and rapidly acquired fortunes. It will, therefore, be many years before the investors and entrepreneurs are forced to direct their attention to foreign fields. Great Britain, before the war, invested over a billion dollars annually in foreign enterprises and at the beginning of the war had between twenty and thirty billions so invested. The United States at that time was a debtor nation for over six billion dollars. While more than this amount was paid off, absorbed or invested during the war, she would need a net investment of nearly twenty-five billions to be on an equal footing with Great Britain in this respect.

11. *Willingness to seek fortune abroad.*—The average family of Great Britain is large compared with that of the United States and there is little room and few opportunities at home for the younger sons. This class of men finds its way into the army, the navy and the mercantile marine and goes abroad as clerks, etc., to foreign and colonial banks and commercial houses. The more venturesome, as soon as they acquire experience, carry British trade and prestige to new and undeveloped countries—British subjects are found everywhere, no matter how remote the place.

The young American, on the other hand, has so many opportunities at home that there is little inducement to venture abroad except for pleasure. He is probably the only son of the family and takes up his father's business or is assisted in setting up in business for himself. If he goes abroad, he is not content with a subordinate position, but wants to be his own master and strike out for himself. Preferably he goes back to his home to do this. We might instance the experience of the International Banking Corporation, a state bank, chartered in Connecticut with foreign branches chiefly in the Orient. This bank, tho an American institution, is manned principally by Englishmen. It will be interesting to watch the personnel of the staff of foreign branches of national banks established under the Federal Reserve Act.

12. *London's discount market.*—The natural complement of a free gold market is a liquid money market capable of absorbing bills of exchange to an almost unlimited amount. This unique feature of the London market makes a first-class bill of exchange on London as acceptable as gold. The strength and broadness of the London market, apart from the natural resources of the country, lie in the ebb and flow of foreign capital thru the machinery of the branches of foreign and colonial banks established there.

Altho London does not particularly encourage the establishment of foreign banks, it, on the other hand, does nothing to restrict the movement and allows free-

dom in banking privileges to all comers of good standing. This broad minded policy, tho it perhaps affects to a certain extent the individual interests of some of the British banks, is recognized as of great importance to London and the country in general, and therefore indirectly to the banks themselves. These branches of foreign banks, with their network of correspondents thruout the world, in addition to their direct influence on the exchange situation, give invaluable assistance to the Bank of England in preserving the equilibrium of the money market.

The policy of New York in connection with foreign banks is just the reverse of that of London and is apparently based on a local and narrow point of view. New York bankers have always discouraged the establishment of foreign banks in their midst and have evoked state legislation and other means to this end. A few foreign banks are represented by agents, not by branches. They cannot take deposits or discount commercial paper and their activities are practically restricted to making call loans and dealing in foreign exchange.

The London discount rates are controlled by a central institution, the Bank of England, and changes in the rate are not only infrequent but seldom rise above six per cent. By this control of the money market thru the bank rate, as it is called, the Bank of England has been able to attract gold to London by raising the rate whenever the exigencies of commerce and the exchange situation require it.

13. *The outlook.*—It is obvious that the preeminence of any commercial center as an exchange center depends upon a wide variety of circumstances which work concurrently to this end. One of the most important is the existance of large capital accumulations seeking employment. It has been pointed out that prior to the Great War this condition existed in a marked degree in the United States but that the opportunities for its employment within that country were so great as to absorb it all and leave little for international ventures. It appears probable that with the enormous burden of taxation under which Great Britain is struggling the prospects for capital accumulation in that country are not so bright as before the War, and that the United States is likely to have a marked advantage in this respect for a number of years to come.

Whether the capital which a people save shall be employed at home or seek foreign markets depends after all upon the relative profitableness of the two undertakings. If the conditions which have prevailed in recent years continue, it may be expected that the international aspects of American finance will continue to grow in importance. New York has taken its place beside London as one of the two great financial centers of the world. To estimate their relative importance at the present time is, as this chapter shows, somewhat difficult; to forecast what it may be in the future would be a most hazardous undertaking.

This much, however, is certain. New York and London are not likely for many years to come to have any important rivals. It seems destined to be a long time before international exchange in the terms of marks or even of francs will become conspicuous matters in the world's financial affairs, and thus become in effect international currencies. For the immediate future the dollar and pound sterling are destined to control world finance.

REVIEW

What is meant by a financial center?

Why is New York the financial center of the United States?

What are present advantages of New York in world finance?

What conditions gave London its supremacy? Distinguish between those which are permanent and those which resulted from historical development.

NOTE. Numerous questions of business practice and procedure are discussed in detail in the Modern Business Reports. The current list contains the following Reports which in their subject matter are more or less related to questions arising in the consideration of International Exchange:

4. Investment Trusts

93. Organizing Export Combinations under the Webb Act.

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